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**Committee of Experts on International Cooperation in Tax Matters**
**Seventeenth session**
Geneva, 16–19 October 2018

# Provisional agenda and organization of work

## Provisional agenda

1. Opening of the session by the Co-Chairs.
2. Adoption of the agenda and organization of work.
3. Discussion of substantive issues related to international cooperation in tax matters:
   - (a) Procedural issues for the Committee;
   - (b) Report of the Subcommittee on Updating the United Nations Model Double Taxation Convention between Developed and Developing Countries;
   - (c) Other issues:
     - (i) Update of the United Nations Practical Manual on Transfer Pricing for Developing Countries;
     - (ii) Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries;
     - (iii) Update of the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries;
     - (iv) Treatment of collective investment vehicles;
     - (v) Dispute avoidance and resolution;
     - (vi) Capacity-building;
     - (vii) Environmental tax issues;
     - (viii) Tax consequences of the digitalized economy — issues of relevance for developing countries;
     - (ix) Taxation of development projects;
     - (x) Other matters for consideration;
     - (xi) Tax issues of royalties.
4. Provisional agenda for the eighteenth session of the Committee.
5. Adoption of the report of the Committee on its seventeenth session.

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## Provisional organization of work

| *Date* | *Item* | |
|---|---|---|
| **Tuesday, 16 October** | | |
| 9–10 a.m. | | Registration of participants |
| 10–10.30 a.m. | 1 | Opening of the session by the Co-Chairs |
| | 2 | Adoption of the agenda and organization of work |
| 10.30–11 a.m. | 3 | Discussion of substantive issues related to international cooperation in tax matters |
| | 3 (b) | Report of the Subcommittee on Updating the United Nations Model Double Taxation Convention between Developed and Developing Countries |
| 11–11.15 a.m. | | Coffee break |
| 11.15 a.m.–12 noon | 3 (b) | Report of the Subcommittee on Updating the United Nations Model Double Taxation Convention between Developed and Developing Countries (*continued*) |
| 12 noon–1 p.m. | 3 (c) (xi) | Tax issues of royalties |
| 1–3 p.m. | | Lunch break |
| 3–4.30 p.m. | 3 (a) | Procedural issues for the Committee (*closed meeting*) |
| 4.30–4.45 p.m. | | Coffee break |
| 4.45–6 p.m. | 3 (a) | Procedural issues for the Committee (*closed meeting*) (*continued*) |
| **Wednesday, 17 October** | | |
| 10–11.30 a.m. | 3 (c) (v) | Dispute avoidance and resolution |
| 11.30–11.45 a.m. | | Coffee break |
| 11.45 a.m.–1 p.m. | 3 (c) (v) | Dispute avoidance and resolution (*continued*) |
| 1–3 p.m. | | Lunch break |
| 3–4.30 p.m. | 3 (c) (ii) | Update of the Handbook on Selected Issues for Taxation of the Extractive Industries by Developing Countries |
| 4.30–4.45 p.m. | | Coffee break |
| 4.45–6 p.m. | 3 (c) (i) | Update of the United Nations Practical Manual on Transfer Pricing for Developing Countries |

| *Date* | *Item* | |
|---|---|---|
| **Thursday, 18 October** | | |
| 10–11.30 a.m. | 3 (c) (ix) | Taxation of development projects |
| 11.30–11.45 a. m. | | Coffee break |
| 11.45 a.m.–1 p.m. | 3 (c) (vii) | Environmental tax issues |
| 1–3 p.m. | | Lunch break |
| 3–4.30 p.m. | 3 (c) (iv) | Treatment of collective investment vehicles |
| 4.30–4.45 p.m. | | Coffee break |
| 4.45–6 p.m. | 3 (c) (vi) | Capacity-building |
| **Friday, 19 October** | | |
| 10–11.15 a.m. | 3 (c) (viii) | Tax consequences of the digitalized economy — issues of relevance for developing countries |
| 11.15–11.30 a.m. | | Coffee break |
| 11.30 a.m.–1 p.m. | 3 (c) (iii) | Update of the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries |
| 1–3 p.m. | | Lunch break |
| 3–3.45 p.m. | 3 (c) (iii) | Update of the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries (*continued*) |
| 3.45–4.45 p.m. | 3 (c) (x) | Other matters for consideration (including international tax evasion and avoidance schemes, and shell companies) |
| 4.45–5 p.m. | | Coffee break |
| 5–5.45 p.m. | 4 | Provisional agenda for the eighteenth session of the Committee |
| 5.45–6 p.m. | 5 | Adoption of the report of the Committee on its seventeenth session; closing of the session |

for Sustainable Development Office (www.un.org/esa/ffd/tax-cooperation/practical-portfolios.html).[1]

4. The paper contained in the annex to the present note is a summary of the United Nations Practical Portfolio on Protecting the Tax Base of Developing Countries against Base Erosion: Income from Services, which is focused on the tax treatment of income from services under the domestic law and tax treaties of developing countries from the perspective of potential tax base erosion and profit shifting.

5. The Portfolio is intended to assist tax officials from developing countries in reviewing the provisions of their domestic law and tax treaties that deal with the taxation of income from services in order to identify the major risks of base erosion and the countermeasures that developing countries can take to reduce or eliminate those risks.

6. One of the major risks of base erosion is transfer pricing abuse with respect to cross-border payments for services between entities that are part of a multinational group. Transfer pricing is not dealt with extensively in the Practical Portfolios because the topic is covered in the United Nations Practical Manual on Transfer Pricing for Developing Countries. Instead, the Practical Portfolio on Income from Services contains a comprehensive identification of the risks of base erosion with respect to income from services and possible countermeasures thereto, in recognition of the widely varying experiences of developing countries, and to provide tax officials from those countries with as much information as possible. In the summary contained in the annex, however, only the most important risks of base erosion with respect to income from services are covered.

7. Neither the Portfolio nor the summary thereof in the annex deals with the domestic law or tax treaties of particular countries, but rather the basic patterns of taxation of income from services that are commonly found in the domestic law and tax treaties of developing countries. Tax officials from developing countries should adapt the materials to their particular situation.

8. The Portfolio comprises four parts: part 1 consists of a general introduction; part 2 includes an analysis of the provisions of the domestic law and tax treaties of developing countries dealing with the taxation of income from services, the risks of base erosion with respect to such income and possible countermeasures; part 3 contains guidance for tax officials from developing countries in designing and drafting domestic legislation and in negotiating tax treaties to counter base erosion and profit shifting; and part 4 includes guidance in the administrative aspects of the provisions of the domestic law and tax treaties of developing countries dealing with income from services.

9. The Portfolio is available only in English. The summary contained in the annex to the present paper is intended to provide access to the basic contents of the Portfolio in the other five official languages of the United Nations. It is not intended as a substitute for the much more comprehensive analysis of the risks of base erosion and possible countermeasures presented in the Portfolio. For more detailed information, readers are encouraged to consult the full text of the Portfolio.

[1] United Nations, Department of Economic and Social Affairs, Financing for Development Office, United Nations Practical Portfolio series, 2017; "Protecting the Tax Base of Developing Countries against Base Erosion: Income from Services"; "Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest and Other Financing Expenses"; and "Protecting the Tax Base of Developing Countries against Base-eroding Payments: Rent and Royalties".

# Annex

## Summary of the United Nations Practical Portfolio on Protecting the Tax Base of Developing Countries against Base Erosion: Income from Services*

## I. Major risks of base erosion with respect to income from services under domestic law

### Introduction

1. A country's tax base may be eroded with respect to income from services if: (a) the country does not tax certain income from services; (b) it allows a deduction for payments for services against its tax base, but does not tax those payments; or (c) the tax on the payments is less than the tax savings resulting from the deduction of the payments.

2. Although the word "services" is not generally defined either in domestic law or tax treaties, it should be given a broad meaning and include any activities performed by one person for another in consideration of a fee. Under domestic law and tax treaties, it is often necessary to distinguish between payments for services and royalties or rent for the use of certain property or equipment, as well as to distinguish between various types of services, including employment, professional and independent services, international shipping and air transportation services, entertainment and sports services and technical services.

### Taxation of residents

3. For developing countries, the risks of base erosion are less serious with respect to income from services derived by its resident taxpayers than to such income derived by non-residents. Therefore, for the purpose of this summary, the risks of base erosion with respect to residents of a developing country and possible countermeasures thereto are dealt with only briefly. For more detailed information concerning the taxation of residents on income from services, readers should consult the Practical Portfolio on Protecting the Tax Base of Developing Countries against Base Erosion: Income from Services.

4. The major risk with respect to the taxation of residents on income from services arises if a developing country taxes on a so-called "territorial" basis, that is, in general, it taxes only income that is sourced in or derived from its territory; it does not tax income derived outside its territory, or foreign source income. The risk can be effectively eliminated if a country imposes tax on the worldwide income of its residents, so-called "worldwide" taxation.

5. Even if a country taxes its residents on their worldwide income from services, including income from foreign countries, there is a risk of base erosion if the country allows a credit for foreign tax on foreign source income and the credit is not limited to the amount of domestic tax on such income since otherwise the credit will, in effect, reduce domestic tax on domestic source income. It is also necessary for any expenses incurred by a resident in earning foreign source income to be allocated to such income for the purpose of computing the limitation on the foreign tax credit.

6. Whether a developing country exempts foreign source income from services or taxes that income with a credit for the foreign tax on the income, the rules for determining the geographical source of the income are very important. If income from

* Prepared by Brian J. Arnold, Senior Adviser, Canadian Tax Foundation.

services is considered to be domestic source income, it should not be exempt from domestic tax under a territorial or exemption system. Furthermore, under a worldwide system, no foreign tax credit should be allowed on any income from services that is considered to be derived from domestic sources. Typically, income from services is considered to be derived from the country in which the services are performed by individuals who are present in that country; however, several developing countries also consider income from services to be earned where the services are used or consumed in the country.

7. Residents of a developing country that taxes on a worldwide basis may avoid such taxation by establishing a controlled foreign corporation to earn income from services performed outside the country. Because a controlled foreign corporation is usually a separate taxable entity and not resident in the country in which the controlling shareholder is resident, the income earned by the corporation will not be taxable by that country. Developing countries can deal with this risk by enacting rules relating to controlled foreign corporations under which the resident shareholders of the corporation are taxable on the income derived by the corporation even if that income is not distributed to them.

**Taxation of non-residents**

8. The risks of base erosion with respect to income from services derived by non-residents depend on whether a country taxes non-resident service providers only on income from services performed in the country or whether it also taxes non-residents on income from services that are used or consumed by residents of the country.

9. In the first case, income from services performed in a country may be taxed on a net basis if a minimum threshold requirement is met, such as a permanent establishment or presence in the country for a minimum period. Other income derived by non-residents from services may be exempt from domestic tax, such as income from employment exercised outside the country, or taxable on a gross basis through a withholding tax.

10. In the second case, income derived by non-residents from services consumed or used in a country is sometimes taxable by that country through a gross-basis withholding tax. This type of tax on services used or consumed by resident individuals is difficult to collect. Therefore, some countries impose tax on payments for services performed outside the country only if the payments to the non-resident service provider are deductible by residents of that country or by non-residents with a permanent establishment in that country who are subject to net-basis taxation by that country. This type of withholding tax is often used by developing countries with respect to payments for consulting, technical or managerial services. For example, Company R, a resident of Country R, provides management services to its wholly owned subsidiary, Company S, resident in Country S. The services are performed by officers and employees of Company R who work exclusively in Country R. In this situation, Company S is likely to deduct the payments to Company R for the management services in computing its income subject to tax in Country S. As a result, Country S may impose a withholding tax on those payments, notwithstanding the fact that the services are performed outside Country S.

# II. Major risks of base erosion with respect to income from services under tax treaties

### Introduction

11. The provisions of tax treaties may sometimes create opportunities for base erosion with respect to income from services because tax treaties often limit the taxes imposed by one contracting State on residents of the other contracting State. For any developing country, the extent to which its bilateral tax treaties allow its domestic tax base to be eroded depends on: (a) how many tax treaties it has concluded; (b) the countries with which it has concluded tax treaties; and (c) the provisions of those tax treaties.

12. In general, tax treaties are based on the United Nations Model Double Taxation Convention between Developed and Developing Countries or the Model Tax Convention on Income and on Capital of the Organization for Economic Cooperation and Development (OECD). Many developing countries negotiate the provisions of their tax treaties on the basis of the United Nations Model Convention because it provides greater taxing rights for source countries.

13. In general, tax is not imposed under the provisions of tax treaties, but under a country's domestic law. Therefore, if an amount of income derived by a non-resident from a country is not taxable under that country's domestic law, the question of whether the country has the right to tax the amount under the provisions of an applicable tax treaty is irrelevant.

14. The provisions of the United Nations and the OECD Model Conventions include rules dealing with the following types of income from services:

(a) Income from employment, as follows:

(i) General rules under article 15;

(ii) Directors' fees and remuneration of top-level managers under article 16;

(iii) Pensions under article 18;

(iv) Government service under article 19;

(b) Income from entertainment and sports activities under article 17;

(c) Income from professional and other independent services under article 14 of the United Nations Model Convention;

(d) Income from other business services under articles 5 and 7, as follows:

(i) Construction under article 5 (3) (a) of the United Nations Model Convention and article 5 (3) of the OECD Model Convention;

(ii) Services furnished by an enterprise under article 5 (3) (b) of the United Nations Model Convention;

(iii) Insurance under article 5 (6) of the United Nations Model Convention.

15. Each of the above-mentioned articles is covered briefly below with respect to the risk of base erosion that they present; however, more emphasis is given to income from business services since they are more prevalent and involve larger amounts of income and greater risk of base erosion.

16. Although tax treaties based on the United Nations and the OECD Model Conventions do not generally limit a country's authority to tax its own residents, pursuant to articles 8 (International shipping and air transport), 18 (Pensions and social security payments) and 19 (Government service), a contracting State's ability

to tax its residents is restricted. Nevertheless, these provisions do not involve serious risks of base erosion and are not discussed further in this summary.

**Income from employment**

17. Under the provisions of article 15 of the United Nations and the OECD Model Conventions, a country in which employment services are exercised is prevented from taxing the income from such services unless the employee is: (a) employed by a resident of that country; (b) employed by a non-resident with a permanent establishment (or a fixed base under the United Nations Model Convention only) in that country and the employment income is deductible in computing the profits attributable to the permanent establishment or the fixed base; or (c) present in that country for more than 183 days in any 12-month period beginning or ending in the relevant fiscal period.

18. The most serious risks of base erosion with respect to income from employment include:

(a) A non-resident employer artificially avoids establishing a permanent establishment or fixed base in a developing country so that the services of non-resident employees of that employer who perform employment services in that country are not taxable there unless the employees are present in the country for more than 183 days in any 12-month period;

(b) The relationship between the payer, or employer, and the service provider, or employee, is structured as an independent contractor relationship, although in substance the relationship is one of employment: if taxpayers are independent contractors, they are subject to tax by the country in which the services are rendered only if they do business through a permanent establishment or a fixed base in that country;

(c) To avoid non-resident employees being employed by an employer resident in a developing country, the employees may be nominally employed by a non-resident agency that hires them out to clients in the developing country, the so-called practice of international hiring out of labour;

(d) Article 15 is limited to income from employment services exercised in a country; as a result, base erosion will occur where a resident employer makes deductible payments of salary to a non-resident employee who performs the duties of employment outside the country.

**Income from entertainment and sports activities under article 17**

19. Some entertainers and sportspersons can make large sums of money in a short period of time. They may be self-employed, employees of an entity such as a team or an orchestra or employees of an entity that they control or own. Under article 17 of the United Nations and the OECD Model Conventions, a contracting State in which a resident of the other State performs entertainment or sports activities is entitled to tax the income derived from such activities without any limitations. Thus, most countries impose withholding tax on the gross amount earned by entertainers and sportspersons resident in the contracting State. Under article 17 (2), the country in which entertainment or sports activities are performed is also entitled to impose tax on any income from those activities that is assigned by the entertainer or sportsperson to a related person, such as a controlled company, a spouse or children.

20. The major risk of base erosion with respect to income from entertainment and sports activities can be attributed to the fact that developing countries may not have the necessary provisions in their domestic law to impose tax on such income.

**Income from professional and other independent services under article 14**

21. Under article 14 of the United Nations Model Convention, a contracting State is prevented from taxing income in respect of professional services and other activities of an independent character performed in that State by a resident of the other contracting State unless the service provider has a fixed base regularly available in the first State or spends at least 183 days in any 12-month period in the first State. To the extent that amounts paid to non-resident professionals or other independent service providers are deductible against a developing country's tax base, that country's tax base will be eroded and the base erosion will not be offset by tax on the non-resident service provider.

22. The major risks of base erosion with respect to article 14 are as follows:

(a) Professionals and other independent service providers resident in countries with which a developing country has tax treaties may earn substantial amounts of income from the developing country without the need for a fixed base in that country or the need to spend 183 days there. As a result, the developing country cannot tax the income even if the payments to the service providers are deductible against the developing country's tax base;

(b) Professionals and other independent service providers resident in countries with which a developing country has tax treaties may earn income from services performed for residents of that country, but provided outside that country. As a result, the payments to the non-resident service providers are deductible against the developing country's tax base but, under article 14, the country is prevented from taxing the income derived by the non-resident service provider.

**Income from other business services under articles 5 and 7**

23. Under article 7 of the United Nations and the OECD Model Conventions, a service provider resident in one contracting State is subject to tax on business profits derived from the other contracting State only if the service provider carries out business in the other State through a permanent establishment located in that State and only to the extent that the profits are attributable to the permanent establishment. A permanent establishment is defined in article 5 as a fixed place of business through which the business of an enterprise is carried on unless that place is limited to carrying on preparatory or auxiliary activities. In addition, a dependent agent who acts in a contracting State on behalf of a person resident in the other contracting State is deemed to be a permanent establishment with respect to such a person if the agent has and habitually exercises the authority to conclude contracts binding on that person or plays the principal role leading to the conclusion of contracts that are routinely approved by that person.

24. The following special rules apply to construction, the furnishing of services by an enterprise and insurance:

(a) Under article 5 (3) (a) of the United Nations Model Convention, a building or construction site or an installation project constitutes a permanent establishment only if the activities last for at least 6 months (12 months under the OECD Model Convention);

(b) The furnishing of services by an enterprise in a country is deemed to be a permanent establishment if the services are performed by its employees, or other personnel engaged by the enterprise for such a purpose, for at least 183 days in any 12-month period (before the updated 2017 to the United Nations Model Convention, under its article 5 (3) (b), the services were also required to be performed for the same or a connected project);

(c) Under article 5 (6) of the United Nations Model Convention, the insurance of risks located in a country or the collection of premiums in a country is deemed to be a permanent establishment.

25. The provisions of articles 5 and 7 of the United Nations and the OECD Model Conventions present several serious risks of base erosion with respect to income from business services. In general, the definition of a permanent establishment provided in article 5 represents a high threshold for the taxation of income from business services. In many circumstances, taxpayers, in particular multinational enterprises, resident in countries with which a developing country has concluded tax treaties can earn substantial amounts of revenue in the developing country without needing to establish a permanent establishment in that country.

26. In some situations, taxpayers may use various tax avoidance strategies to avoid having a permanent establishment in a developing country. For example, some taxpayers may be able to:

(a) Shift the location of their business activities from place to place within a country so that the activities do not take place in one location for more than 183 days;

(b) Provide services for different or unconnected projects within a developing country for more than 183 days;

(c) Limit construction activities within a developing country to a duration of less than 6 months, or 12 months if the treaty includes the time threshold proposed in the OECD Model Convention is applied.

(d) Split activities, such as construction, in a developing country among related entities so that no one entity has a permanent establishment, although if the activities are aggregated, there would be a permanent establishment in the country;

(e) Provide services, such as digital services, outside a developing country for clients in the developing country so that payments for the services are deductible against the developing country's tax base but, under the provisions of a treaty, the developing country is prevented from imposing tax on the non-resident service provider with respect to those payments;

(f) Pay an amount for the services that is greater or less than their fair market value, that is, the amount that would be paid for the services by persons dealing at arm's length with one another, if a non-resident service provider and a client resident in a developing country are related or are not dealing at arm's length;

(g) Carry out substantial insurance activities in a developing country without establishing a permanent establishment in the country, unless the tax treaties of the developing country include provisions similar to article 5 (6) of the United Nations Model Convention.

# III. Countermeasures to prevent base erosion with respect to income from services

### Introduction

27. Each developing country must decide for itself whether and to what extent it is concerned about the risks of base erosion with respect to income from services and, if so, how to best deal with those risks. Identified in the present section are possible countermeasures that developing countries might adopt to deal with the major risks of base erosion resulting from the provisions of a developing country's domestic law or from its tax treaties with respect to income from services. The information is intended as guidance, not a recommendation, for developing countries to take into

account when considering whether to adopt countermeasures to prevent base erosion and the application of those measures.

**Countermeasures under domestic law**

28. Developing countries normally tax some non-resident service providers on a net basis and some on a gross withholding tax basis. In general, non-residents are taxable on a net basis only if they have a substantial presence in a country, which facilitates gathering the necessary information and collecting the tax. Taxing non-residents on a net basis imposes significant compliance costs on the non-residents and the tax authorities: tax returns must be filed and assessed, and tax must be collected. To ensure collection of the tax, some countries impose an obligation on residents to withhold tax on payments for services made to non-residents, even if the non-residents are taxable on a net basis; they may also require non-residents who are taxable on a net basis to pay tax instalments periodically.

29. Where non-resident service providers are taxable on a net basis under a developing country's domestic law only if they have a substantial presence in the country, such as a permanent establishment or a physical presence for a substantial period of time, they may use various tax avoidance strategies to avoid having the substantial presence. To counter or minimize the risks of base erosion, a developing country might consider the following options:

(a) Not having a substantial presence threshold in its domestic law for taxing non-resident service providers, although such a rule may be difficult to enforce and may discourage non-residents from performing services in the country;

(b) Designing a threshold requirement that is difficult to avoid and supplementing it with anti-avoidance measures: for example, services provided by non-residents in different places in a developing country and by related or associated enterprises could be aggregated for the purposes of determining whether any threshold is met; similarly, multiple contracts entered into with the same client could be aggregated and any presence test could be based on a non-resident's aggregate presence over a longer period of time rather than on a continuous period of presence.

30. These considerations apply equally to construction services and professional and other independent personal services. Developing countries should carefully consider the relationship between any domestic thresholds for the taxation of non-resident service providers and the threshold requirements in their tax treaties, as discussed in paras. 39 to 47 below.

31. With respect to non-resident insurance companies doing business in a developing country, the country might consider taxing the companies if they perform certain activities, such as collecting premiums or insuring risks in the country, and then ensuring that they include article 5 (6) of the United Nations Model Convention in their tax treaties to protect the imposition of domestic tax on non-resident insurance companies. Otherwise, the insurance companies may be able to derive substantial amounts of income from a country without paying any tax on the income. Moreover, to the extent that the insurance premiums are deductible against the developing country's tax base, there will be further base erosion.

32. If a non-resident service provider does not have a substantial presence in a developing country, the only feasible method by which the country can impose tax on the non-resident is through a withholding tax on the gross service fees. The persons paying for the services — residents and non-residents doing business in the country through a permanent establishment or a fixed base — are required to withhold an amount from the payment as tax or in account for the final tax payable and remit that amount to the tax authorities. A developing country might also consider denying any

deduction for payments to non-residents in consideration for services; however, in most cases, the payments will represent legitimate expenses that should be deducted. An alternative way to prevent base erosion would be to make withholding a condition for the deduction of the payments. Thus, no deduction for payments to non-residents for services would be allowed unless the payer were to withhold tax from the payments, so that the withholding tax would offset the erosion of the tax base from the deduction.

33. The rate of withholding tax imposed by developing countries on payments to non-residents for services is an important issue. In principle, the rate should be a proxy for a tax on the net income derived by the service provider. If the rate is excessive, it may discourage non-residents from providing services to residents of developing countries or force them to pass the tax on to their clients in those countries, making the cost of such services higher. If different rates of withholding tax are imposed on different types of services, the compliance burden on withholding agents will be increased; therefore, if possible, the same rate of withholding tax should be applied to all payments for services. Typically, however, many developed and developing countries impose withholding taxes only on payments to non-resident entertainers and sportspersons and on remuneration paid to non-resident employees, including directors and officers of resident companies; they do not impose withholding tax on payments for services to non-residents who have a substantial presence, such as a permanent establishment, in the country and are taxable on a net basis. Several developing countries also impose withholding taxes on payments to non-residents for technical services.

34. A developing country must decide whether withholding taxes on payments to non-residents for services will be limited to services performed in the country or extend to payments for services performed outside the country but consumed or used inside the country. This issue often arises with respect to fees for consulting, technical and management services. For example, a multinational company may establish a group company in a low-tax country to provide consulting, technical or management services to another group company in a developing country. Some or all of these services may be performed outside the developing country; however, the payments for the services may be deductible under that country's domestic law, irrespective of where they are performed. Furthermore, as discussed below, under the article on non-discrimination of the United Nations and the OECD Model Conventions, payments to residents of a treaty partner must be deductible on the same terms as they would be if the payments were made to residents of the developing country. The deduction of the payments for services against the developing country's tax base provides a justification to impose withholding tax on the payments, even if the services are performed outside the developing country.

35. Payments for services by residents of a developing country to related non-resident persons, in particular non-resident persons resident in low-tax countries, pose special risks of base erosion. Most countries have transfer pricing rules to prevent residents from making deductible payments to related non-residents for services in excess of the fair market value or arm's length price of the services. Transfer pricing rules are very difficult for developing countries to apply effectively, however. Therefore, developing countries could consider imposing withholding taxes on common types of intragroup services, such as consulting, technical and management services, as well as protecting the application of the withholding taxes in their tax treaties by including article 12A of the 2017 United Nations Model Convention in all their treaties, as discussed below.

36. Typically, an obligation to withhold payments to non-residents for services is imposed on resident businesses and non-residents with a permanent establishment or fixed base in a country. These payers will generally claim a deduction for the

payments and, as a result, the withholding tax is necessary to offset the erosion of the tax base caused by the deduction. An obligation to withhold is not generally imposed on individual consumers resident in a country who pay amounts to non-residents for services, because the consumers are not usually entitled to deduct the payments and it is difficult to enforce an obligation to withhold against individuals. Failure to withhold should be subject to interest and penalties, and many countries impose joint liability on the withholding agent for the amount of the tax. In addition, the deductibility of payments to non-residents for services can be made conditional on the payer withholding the appropriate amount of tax from the payment.

37. The following types of payments to non-residents for services are often subject to withholding tax:

(a) Salary, wages and other remuneration, including pensions, paid to non-resident employees by resident employers, non-resident employers with a permanent establishment or fixed base in the country or the Government;

(b) Directors' fees and remuneration of top-level managers paid by companies resident in a developing country;

(c) Amounts paid to non-resident entertainers or sportspersons for services performed in a developing country by the promoter of the event or the owner of the venue;

(d) Deductible payments for international shipping or air transportation services;

(e) Amounts paid to non-residents for consulting, technical or management services.

38. Although withholding taxes are typically applied to actual payments to non-resident service providers, there are circumstances in which it is necessary for withholding taxes to be applied to deemed payments, such as deemed amounts paid pursuant to transfer pricing rules and deemed payments on the accrual of deductible expenses.

**Countermeasures under tax treaties**

39. Some provisions of the United Nations and the OECD Model Conventions limit the taxation measures of domestic law. If possible, developing countries should avoid including these measures in their tax treaties or modify them so that the treaties will not prevent the application of countermeasures against base erosion in domestic law. Through other provisions of the Model Conventions, developing countries are granted taxing rights with respect to income from services and taxpayers are prevented from engaging in tax avoidance strategies in order to obtain treaty benefits inappropriately. If possible, developing countries should ensure that these provisions are included in their tax treaties.

40. Developing countries may consider modifying or not including the provisions contained in the following articles of the United Nations and the OECD Model Conventions in their tax treaties:

(a) Article 14: it might be possible for a developing country to negotiate a shorter time period — 90 or 120 days, rather than 183 days — for a non-resident performing professional or other independent services in the country to be subject to tax on the income from such services;

(b) Articles 5 and 7: it might be possible for a developing country to negotiate a shorter time period than the existing 183-day period for recognition of a services-related permanent establishment under article 5 (3) (b) of the United Nations Model

Convention and to delete the "same or connected project" requirement that was previously included in article 5 (3) (b). Developing countries could also consider adopting a time period for construction projects that is shorter than the six-month period included in article 5 (3) (a) and negotiating a special provision that would allow construction projects at different sites within the country to be aggregated;

(c) Article 24 (3): through the provision in this article, a country is prevented from discriminating against a non-resident employer with a permanent establishment in the country relative to a resident employer in the same circumstances. Most countries will insist on the inclusion of this provision in their treaties. The provision does not present any difficulties for developing countries so long as they require resident employers to withhold tax from the salary and wages of non-resident employees and do not deny non-resident employers the right to claim a deduction for the salary and wages paid to non-resident employees in computing the profits attributable to the permanent establishment;

(d) Article 24 (4): if a developing country wishes to deny the deduction of payments to residents of its treaty partners for certain services, it must avoid including article 24 (4) in its treaties or modify that provision to exclude payments to non-residents for those services.

41. Developing countries should consider including the following articles of the United Nations Model Convention in their tax treaties:

(a) Article 15, which includes a special provision to prevent the international hiring out of labour (see para. 1 of the commentary on article 15 of the United Nations Model Convention);

(b) Article 16, to require resident companies paying directors' fees and the remuneration of top-level managers to withhold tax on such payments in accordance with the developing country's domestic law;

(c) Article 19, to permit the Government of a developing country to tax remuneration paid by it to non-resident employees;

(d) Article 18 B, to allow a developing country to tax pensions paid to non-resident employees;

(e) Article 17, including its paragraph 2, to allow a developing country to tax all income from entertainment or sports activities performed in the country, including any such income assigned to another person;

(f) Article 5, including the anti-avoidance rules added in 2017, to prevent the artificial avoidance of permanent establishment status;

(g) Article 5 (6), to allow a developing country to tax income from the collection of insurance premiums or the insurance of risks in the country;

(h) Article 29 (9), which comprises the general anti-abuse rule added in 2017, to allow a developing country to deny treaty benefits in abusive situations.

42. As noted above, multinational corporations can erode a developing country's tax base by using a group company established in a low-tax jurisdiction to provide various types of services — consulting, technical or management services — to another group company doing business in the developing country. The fees for services paid by the group company in the developing country are typically deductible against the country's corporate tax base. Although the developing country may impose withholding on the fees under its domestic law, the provisions of a tax treaty between the developing country and the country in which the service provider is resident may prevent the imposition of any withholding tax on the fees.

43. To deal with this risk of base erosion, developing countries can avoid concluding any tax treaties, in particular with low-tax countries, which is a drastic response with possibly disadvantageous consequences, or insist on the inclusion of provisions in their tax treaties that allow them to impose withholding tax at a reasonable rate on deductible payments for services. For many developing countries, entering into tax treaties is an important means of attracting foreign investment. Therefore, it is important for them to include provisions in their tax treaties, such as article 12A of the 2017 United Nations Model Convention, that allow them to impose withholding tax on payments for services.

44. Under article 12A, a contracting State may impose tax on fees for technical services "arising" in that State and paid to a resident of the other contracting State at a rate agreed by the two States. Fees for technical services are deemed to arise in a State in which the payer is a resident, or a non-resident with a permanent establishment or fixed base in that State, and the fees are deductible in computing the profits attributable to the permanent establishment or fixed base. If, however, the non-resident service provider has a permanent establishment or fixed base in the contracting State in which the fees for technical services arise, the fees are taxable on a net basis, in accordance with article 7 of the United Nations Model Convention.

45. Fees for technical services are defined as payments for consultancy, technical and management services, except for the following payments: (a) to employees, because, as explained above, the risks of base erosion are small — non-resident employees performing services in a country for an employer resident in that country or a non-resident with a permanent establishment in that country are taxable by that country under article 15; (b) for teaching in or by an educational institution, which is excluded because such activities are considered to be desirable and the risks of base erosion are small; and (c) for services for the personal use of any individual, because such payments are not deductible by the payer and the risks of base erosion are small.

46. Although the words "consultancy", "technical" and "management" are not defined and, therefore, have their ordinary meanings they are not intended to have the meanings that they have under the domestic law of the country applying the treaty. As explained in the commentary on article 12A, technical services include services that require specialized knowledge, skill or expertise and do not include routine standardized services. Furthermore, technical services include only specialized services that are performed for the benefit of a client; they do not include specialized services that are performed by an enterprise for itself. Thus, for example, if an enterprise uses specialized services to develop standardized goods or services that it sells to its clients, those services would not be technical services, according to the meaning explained in article 12A.

47. The definition of fees for technical services involves difficult distinctions between technical services and other services, causing inevitable uncertainty. The commentary on article 12A contains an alternative provision for developing countries that wish to avoid this uncertainty. Under the alternative provision, the contracting State in which payment for any services, other than the fees for services excluded under article 12A, arises is entitled to impose withholding tax on the gross amount of the payment to a resident of the other contracting State, but only if the services are performed in the first State or are paid to a closely related person in the other State. Thus, under the alternative provision, a developing country can tax all payments for services — technical and other services — performed in the country, but it can tax payments for services performed outside the country only if the services are provided by a resident of the other country that is closely related to the payer for the services. The alternative provision may be attractive to developing countries because it avoids the uncertainty involved in distinguishing between technical and other services and targets intragroup services that pose the greatest risk of base erosion.

**Tax administration issues**

48. In general, non-resident service providers may be taxable on their net income in the same manner as residents or on the gross payments that they receive for their services without any deductions. If non-residents are subject to tax on their net income from services, they are usually required to file tax returns showing their income subject to tax and the tax payable. Although the payments for services that they derive may be subject to withholding, such withholding is provisional; it represents payments owed because of the non-resident's tax payable as finally established by the assessment of the non-resident's tax return. If non-resident service providers are subject to withholding taxes on the gross payments they receive from their clients, the tax withheld is usually the final tax. The non-resident is not allowed to pay tax on a net basis, although in some circumstances a non-resident may be allowed to file a tax return and claim a refund for excessive tax withheld.

49. If non-resident service providers are taxable by assessment, the tax authorities face the difficult task of identifying non-resident service providers that are required to file tax returns. This difficulty can be minimized if non-resident service providers are subject to interim or final withholding. To the extent that non-resident service providers are subject to withholding, the obligation to identify non-residents subject to tax and the amount of the tax is effectively shifted to the withholding agents.

50. In order to administer the provisions of domestic law and tax treaties effectively, the tax authorities must have the power to gather the necessary information from the taxpayer and other entities, such as financial institutions and withholding agents, and to audit the provisions of domestic law and verify that they have been complied with. Therefore, developing countries should consider whether the disclosure and information-reporting requirements under domestic law and the resources devoted to audit and verification activities are adequate for this purpose.

51. The tax authorities of developing countries also need to apply the provisions of their tax treaties with respect to the taxation of income from services. In this regard, the application of tax treaties involves the determination of:

(a) The residence of a non-resident service provider — often, certificates of residence from the foreign tax authorities are required for this purpose;

(b) The applicable article of the treaty;

(c) Whether the non-resident service provider qualifies for the benefits of the particular article of the treaty;

(d) The profits attributable to a permanent establishment or fixed base, in accordance with the provisions of article 7 or 14 of the United Nations Model Convention;

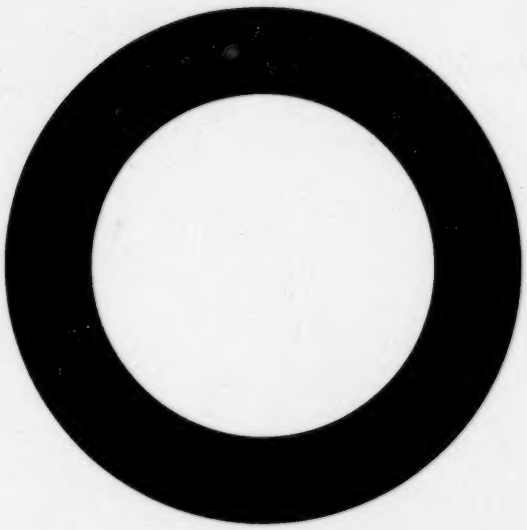
(e) Whether the payments to associated non-residents for services conform to arm's length amounts;

(f) Whether the proper amount of withholding tax has been withheld in accordance with the relevant article of the treaty, and whether any excess amount must be refunded.

**Checklist of the major risks of base erosion and possible countermeasures**

| *Risks* | *Countermeasures* |
|---|---|
| *Income from employment* | |
| • Non-resident employees working for a permanent establishment or fixed base of a non-resident inside a country | • Impose withholding obligation on employer and deny deduction if no withholding |
| • Non-resident employees working for a permanent establishment or fixed base of a non-resident outside a country | • Impose withholding obligation on employer and deny deduction if no withholding; ensure that tax treaties do not prevent collection of domestic tax |
| • Non-resident employees who are, in substance, employees of a resident employer, but legally employed by a non-resident employer (international hiring out of labour) | • Apply special provision in tax treaties, or domestic or treaty anti-abuse rule |
| • Non-residents who are, in substance, employees of a resident employer, but are legally independent contractors | • Determine employment relationship on the basis of economic substance<br>• Apply domestic or treaty anti-abuse rule |
| • Remuneration of non-resident directors and top-level managers | • Ensure that amounts are taxable under domestic law and that resident companies have an obligation to withhold; include article 16 in tax treaties |
| *Income from entertainment and sports activities* | |
| • Short-term entertainment and sports activities of non-residents in a country where non-residents earn substantial amounts | • Tax all income from entertainment and sports activities of non-residents in the country; include article 17 in tax treaties |
| • Income from entertainment and sports activities is assigned to another person | • Ensure that domestic law contains anti-avoidance rules and that treaties include article 17 (2) |
| *Business, professional and other independent services* | |
| • Non-residents performing substantial services in a country without having a permanent establishment or fixed base in the country, in particular where non-residents artificially avoid having a permanent establishment or fixed base | • Ensure that domestic law and/or tax treaties contain anti-avoidance rules<br>• Negotiate a shorter time period for construction and services-related permanent establishments |
| • Non-residents performing substantial services outside a country for clients who are resident or carrying out business in the country, in particular where those clients claim deductions for payments to the non-resident service providers | • Ensure that payments for services are taxable under domestic law and impose the obligation to withhold on payers with the denial of deductions if they fail to withhold; also ensure that tax treaties do not prevent domestic taxation |

| *Risks* | *Countermeasures* |
| --- | --- |
| • Substantial income earned by non-resident insurance companies without a permanent establishment in a country | • Ensure that insurance companies are taxable on income from insuring risks or collecting premiums without the need for a permanent establishment and include article 5 (6) in tax treaties |
| • Payments by residents for services provided by related non-residents where the amount of the payments is greater or less than the arm's length amount | • Apply transfer pricing rules effectively |
| • Non-residents performing services, such as technical services, outside a country for clients who are resident or carrying out business in the country, in particular where those clients claim deductions for the payments to the non-resident service providers | • Impose withholding tax on such payments irrespective of where the services are performed and include article 12A of the United Nations Model Convention in tax treaties |



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Item 3 (c) (vi) of the provisional agenda*
**Discussion of substantive issues related to international cooperation in tax matters: other issues: capacity-building**

# Summary of the Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest

## Note by the Secretariat

1. In its resolution 2017/2, the Economic and Social Council recognized the progress made by the Financing for Sustainable Development Office of the Department of Economic and Social Affairs of the Secretariat in developing, within its mandate, a capacity development programme in international tax cooperation aimed at strengthening the capacity of the ministries of finance and the national tax authorities in developing countries to develop more effective and efficient tax systems, which support the desired levels of public and private investment, and to combat tax evasion, and requested the Office, in partnership with other stakeholders, to continue its work in this area and to further develop its activities, including relevant practical tools.

2. One of the areas of focus of the above-mentioned programme is strengthening the capacity of developing countries to increase the potential for domestic revenue mobilization by enhancing their ability to effectively protect and broaden the tax base. The main tools developed in this area are: (a) the *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries*; and (b) a series of United Nations Practical Portfolios on Protecting the Tax Base of Developing Countries.

3. The Practical Portfolios are aimed at complementing and operationalizing the guidelines contained in the *United Nations Handbook* through more in-depth and hands-on practical guidance on dealing with various aspects of tax base erosion tailored to developing countries. To date, three Practical Portfolios have been completed and are

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available in digital format on the website of the Financing for Sustainable Development Office (www.un.org/esa/ffd/tax-cooperation/practical-portfolios.html).[1]

4. The paper contained in the annex to the present note is a summary of the Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest, which focuses on the deduction of interest and other financing expenses under the domestic law and tax treaties of developing countries from the perspective of potential tax base erosion and profit-shifting.

5. The Practical Portfolio on Interest is intended to assist tax officials from developing countries in reviewing the provisions of their domestic law and tax treaties dealing with the deduction of interest (any references to interest in the summary are intended to include other financing expenses) in order to identify the major risks of base erosion and the countermeasures that these countries might take to reduce or eliminate those risks.

6. One of the major risks of base erosion is transfer pricing abuses with respect to cross-border payments of interest between entities that are part of a multinational group. Transfer pricing is not dealt with extensively in the Practical Portfolios because the topic is covered separately in the *United Nations Practical Manual on Transfer Pricing for Developing Countries*. Instead, the Practical Portfolio on Interest presents a comprehensive identification of the risks of base erosion with respect to the deduction of interest expenses and the possible countermeasures to those risks in recognition of the widely varying experiences of developing countries and in order to provide tax officials from developing countries with as much information as possible. In the summary, however, only the most important risks of base erosion with respect to interest expenses are dealt with.

7. Neither the Practical Portfolio on Interest nor the summary deal with the domestic laws or tax treaties of particular countries. Instead, they deal with the basic patterns of taxation with respect to interest expenses that are commonly found in the domestic laws and tax treaties of developing countries. Thus, tax officials from developing countries should adapt the materials to their particular situation.

8. The Practical Portfolio on Interest contains four parts. Part 1 consists of a general introduction. Part 2 provides an analysis of the provisions of the domestic law and tax treaties of developing countries dealing with the deduction of interest by residents and non-residents, the risks of base erosion with respect to such income and the possible countermeasures. Part 3 provides guidance for tax officials from developing countries on designing and drafting domestic legislation and negotiating tax treaties to counter base erosion. Part 4 provides guidance concerning the administrative aspects of the provisions of the domestic laws and tax treaties of developing countries dealing with the deduction of interest expenses.

9. The Practical Portfolio on Interest is available only in English. The summary contained in the annex to the present note is intended to provide access to the basic contents of the Portfolio in the other five official languages of the United Nations. It is not intended as a substitute for the much more comprehensive analysis of the risks of base erosion and possible countermeasures presented in the Portfolio, and readers are encouraged to consult the full Portfolio for more detailed information.

[1] United Nations, Department of Economic and Social Affairs, Financing for Development Office, United Nations Practical Portfolio series, 2017; "Protecting the Tax Base of Developing Countries against Base Erosion: Income from Services"; "Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest and Other Financing Expenses"; and "Protecting the Tax Base of Developing Countries against Base-eroding Payments: Rent and Royalties".

# Annex

## Summary of the Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest[a]

## I. Major risks of base erosion with respect to the deduction of interest under domestic law

### Introduction

1. Base erosion with respect to interest may occur in the following situations:

(a) The deductions of interest are excessive for some reason;

(b) Interest payments received by non-residents are not taxable or are taxable at a reduced rate by the country in which the payer is resident or carrying on business;

(c) Any income earned from the use of the funds on which the interest is paid is not subject to tax or is taxed at a preferential rate by the country in which the payer is resident or carrying on business;

(d) Any combination of the preceding three situations.

Although all deductions of interest erode a developing country's tax base, in most circumstances, interest expenses represent legitimate expenses incurred to earn income that are properly deductible.

2. The risks of base erosion with respect to interest paid to non-residents are greater where:

(a) The payments are deductible by the payer against a developing country's tax base, but are not taxable to the recipient or are taxable at a reduced rate by that country under domestic law or an applicable tax treaty. For example, the deduction of interest will usually result in a reduction of corporate tax in the developing country, but will often not be completely offset by withholding tax on the interest, which will usually be imposed at a rate lower than the corporate rate;

(b) The deductions are excessive because the taxpayer has incurred too much interest expense relative to its debt or its financial earnings;

(c) The deductions are excessive because the interest is paid to a related person and the interest rate exceeds the arm's length rate or the taxpayer has incurred more than an arm's length amount of debt.

### Basic concepts

3. Dealing effectively with base-eroding payments of interest requires the tax authorities to distinguish between interest and other payments, especially dividends, and their underlying obligations — debt and equity. Under the tax systems of most countries, interest paid on a company's debt is deductible but dividends paid on a company's shares are not deductible; further, interest received by a company is usually taxable but dividends received with respect to a substantial holding of shares in another company are often exempt from tax.

4. In general, interest is compensation for the use of money, whereas dividends are an after-tax return on an investment in shares of a company. The meaning of "interest"

[a] Prepared by Professor Brian J. Arnold, Senior Adviser, Canadian Tax Foundation, Toronto, Canada.

for purposes of a developing country's tax system should ideally depend on the substance of the underlying obligation on which the interest is paid and not simply on the legal form of that obligation as debt. Moreover, amounts, such as discounts, that are economically equivalent to interest (that is, they are linked to a financing and computed as a percentage of principal) should ideally be treated the same as interest for tax purposes. For the purpose of the Practical Portfolio on Interest and the present summary, references to interest are intended to include any amounts that are economically equivalent to interest.

5. Hybrid financial instruments are instruments that are treated as debt by one country and as equity by another country; as a result of this inconsistent treatment, they can be used to erode the tax base of developing countries in certain circumstances. For example, a company resident in a country that is part of a multinational group may issue redeemable preferred shares to another group company resident in another country. The first country may treat the shares as debt and any payments on the shares as deductible interest payments, whereas the country in which the holder is resident may treat the shares as equity and the payments on the shares as exempt dividends.

6. In many countries, interest is deductible if it is incurred for the purpose of earning income that is subject to tax; as a result, it is often necessary to determine whether interest expense is incurred to earn taxable income. Three basic methods — tracing the use of borrowed funds, ordering rules under which a positive or negative assumption is made about the use of borrowed funds, and apportionment of borrowed funds to assets or income — are used to determine whether interest is deductible.

7. Where interest is paid by a resident of one country to a related person resident in another country, the potential for base erosion is increased. Transfer pricing is a serious concern where the interest charged is more or less than an arm's length rate, or if the amount of debt on which the interest is paid exceeds an arm's length amount of debt.

**Excessive interest expenses**

8. The most serious risks of base erosion through interest payments involve excessive payments of interest by resident entities to related non-residents, for example, payments of deductible interest by a subsidiary to its parent company. There are three aspects of the problem of excessive interest deductions:

(a) Transfer pricing issues, as mentioned above;

(b) Thin capitalization, where a resident company claims interest deductions for interest paid to non-residents on an excessive amount of debt relative to its equity;

(c) Earnings stripping, where a resident company claims interest deductions that are excessive relative to the company's earnings or to a standard financial measure of earnings, such as earnings before interest, taxes, depreciation and amortization.

Several countries, including some developing countries, have adopted thin capitalization rules or earnings-stripping rules to restrict excessive interest deductions. These rules are discussed below.

**Residents incurring interest expenses to earn foreign-source income**

9. There are two basic patterns for taxing residents:

(a) "Territorial" taxation, under which a country taxes only income that is sourced in or derived from its territory; foreign-source income is effectively exempt from tax;

(b) "Worldwide" taxation, under which a country imposes tax on the worldwide income of its residents, including any foreign-source income.

10. Under a territorial system, any interest expenses incurred by residents of a developing country to earn foreign-source income that is exempt from tax should logically not be deductible. It may be difficult for the tax authorities to determine whether interest expenses are properly allocated to exempt foreign-source income (and should in principle not be deductible) or to taxable domestic-source income (and should in principle be deductible). This determination depends on the method — tracing, ordering rules, or apportionment — used by the developing country to allocate interest to sources of income. If tracing is used for this purpose, as is the case in many countries, large enterprises will usually be able to structure their financing arrangements so that interest is deductible against the tax base of the residence country.

11. Even if a country taxes its residents on their worldwide income, including income from foreign countries, there is a risk of base erosion where:

(a) Foreign-source income is taxable on a preferential basis (for example, it is taxable at a lower rate than the generally applicable rate);

(b) The country allows a credit for foreign tax on the foreign-source income and the credit is not limited to the amount of domestic tax on such income (because otherwise the credit will reduce domestic tax on domestic-source income). For this purpose, it is necessary for any expenses incurred by a resident to earn foreign-source income, especially interest expenses, to be allocated to such income for purposes of computing the limitation on the foreign tax credit.

12. As noted above, whether a developing country exempts foreign-source income or taxes that income with a credit for the foreign tax on the income, the rules for determining the geographical source of the income and the allocation of expenses to the income are very important. Under a territorial system, in principle, any interest expenses allocated to domestic-source income should be deductible, but any interest expenses allocated to foreign-source income should not be deductible. Under a worldwide system, any interest expenses incurred to earn foreign-source income should be allocated to that income for purposes of the domestic limitation on the foreign tax credit.

13. A common form of base erosion encountered by many countries involves a resident company incurring interest expenses on borrowed funds used to acquire shares of a foreign company. In this situation, the interest is often deductible against the tax base of the country in which the parent company is resident (the residence country), but the income earned by the foreign company is not usually subject to tax by the residence country when it is earned and dividends received by the parent company may be exempt from tax by the residence country or may not be subject to tax until received in a subsequent year. Thus, interest is deductible currently in the year incurred even though the related income is exempt from tax, or is subject to preferential tax, or tax is deferred until dividends are received. In all three cases, the tax base of the residence country is effectively eroded by the mismatch in the timing of the interest deductions and the taxation of the dividends and by the difference between the tax saving from the interest deductions and any tax on the dividends received from the foreign company or on a gain from the disposition of the shares of the foreign company.

**Withholding tax on interest**

14. Many developing countries impose withholding tax on interest paid by residents to non-residents. Often, withholding tax on interest is shifted by the non-resident

lender to the resident borrower by requiring the borrower to gross-up the interest payments so that the lender receives a net amount after the deduction of the withholding tax equal to its expected rate of return on a loan not subject to withholding tax; in effect, the withholding tax is borne by the resident borrower and the economic effect is to increase financing costs for residents.

15. Withholding tax on interest paid to non-residents may serve to offset the revenue loss from the deduction of the interest by the resident payer. For example, assuming that a developing country has a corporate tax rate of 30 per cent and imposes withholding tax on interest paid to non-residents at a rate of 30 per cent, the withholding tax will completely offset the reduction in corporate tax as a result of the interest deduction. However, if the rate of withholding tax on interest is less than the corporate tax rate (which is the case in many countries because the withholding tax is imposed on the gross amount of interest or because the rate of withholding is reduced pursuant to a tax treaty), the reduction of the corporate tax will not be completely offset and base erosion will result.

**Deduction of interest by non-residents**

16. Typically, non-residents are taxable on their income derived from a developing country either on a net basis or a gross withholding tax basis. Where non-residents are taxable on a gross withholding basis (generally on investment income such as dividends, interest and royalties), no deductions are allowed and base-eroding payments of interest are not a concern. However, where non-residents are taxable by a developing country on a net basis, which usually occurs only where non-residents carry on substantial business activities in the country, they will usually be entitled to claim deductions for any expenses, including interest, incurred in earning the income. These interest expenses are legitimate expenses that are properly deductible, assuming that they are incurred for the purpose of earning the income taxable by the developing country. However, there is a risk that non-residents, when computing income taxable by a developing country, may claim interest expenses that are not properly allocated, in whole or in part, to the business activities carried on in that country. The allocation of interest expenses to income earning activities depends on the method of allocation — tracing, ordering rules, or apportionment — used by a country, as discussed above. If a country uses tracing, multinational enterprises can usually structure their financing arrangements to maximize their interest deductions.

17. Interest deductions claimed by non-residents in computing taxable income from a business carried on in a developing country erode the tax base of that country irrespective of whether the interest is paid to a resident or a non-resident of that country. However, the risks of base erosion are more serious where interest paid to non-residents is not subject to tax or is subject to a reduced rate of tax by the developing country.

18. The tax base of a developing country may be eroded by excessive payments of interest by non-residents that are taxable on a net basis in the same way as discussed above with respect to excessive payments of interest by residents. For example, non-residents may pay interest to related persons at a rate that exceeds an arm's length rate; they may have excessive levels of debt compared with arm's length parties; and they may pay interest that is excessive as regards their earnings (for example, interest in excess of a certain percentage of their earnings before interest, taxes, depreciation and amortization).

# II. Major risks of base erosion with respect to interest under tax treaties

### Introduction

19. The provisions of tax treaties may sometimes create opportunities for base erosion with respect to interest expenses because tax treaties often limit the taxes imposed by one contracting State on residents of the other contracting State. Obviously, for any particular developing country, the extent to which its bilateral tax treaties allow its domestic tax base to be eroded depends on: (a) how many tax treaties it has concluded; (b) the countries with which it has concluded tax treaties; and (c) the provisions of those tax treaties.

20. In general, tax treaties are based on either the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention) and the Model Tax Convention on Income and on Capital of the Organization for Economic Cooperation and Development (OECD Model Convention). Many developing countries negotiate the provisions of their tax treaties based on the United Nations Model Convention because it provides greater taxing rights for source countries.

21. Tax treaties do not generally impose tax; tax is imposed pursuant to a country's domestic law. Therefore, if an amount of income derived by a non-resident from a country is not taxable under that country's domestic law, it is irrelevant whether the country has the right to tax the amount under the provisions of an applicable tax treaty.

22. There are two major questions with respect to the treatment of interest under tax treaties. First, do tax treaties restrict a country's authority to impose withholding tax on interest payments made to residents of the other contracting State under its domestic law? Second, do tax treaties require countries to allow the deduction of interest by residents of the other contracting State in circumstances where no deduction would be allowed under domestic law?

### Withholding tax on interest

23. Under article 11 (2) of the United Nations and OECD Model Conventions, where interest arises in a contracting State and is paid to a resident of the other State, the gross amount of the interest may be taxed by the State in which the interest arises. If the recipient is also the beneficial owner of the interest, the rate of tax on the interest is limited to the rate agreed by the contracting States (the OECD Model Convention proposes 10 per cent of the gross amount of the interest payments). Interest arises in a contracting State where the payer is a resident of that State or where a non-resident has a permanent establishment (or fixed base) in that State, the debt was incurred in connection with the permanent establishment (or fixed base) and the interest is deductible in computing the profits attributable to the permanent establishment (or fixed base).

24. In general, if article 11 (2) applies, a developing country's withholding tax on interest paid to a non-resident is reduced to the rate specified in the article. Although this reduction in tax can be seen as a form of base erosion, by adopting article 11, the developing country has agreed to the reduction through bilateral negotiations with the other country as part of the entire package of tax treaty provisions. However, the tax authorities must administer the provisions of article 11 to ensure that a non-resident qualifies for its benefits. For this purpose, the tax authorities must determine that:

(a) The recipient of the interest is a resident of the other country under the treaty;

(b) The interest arises in the country;

(c) The non-resident recipient of the interest is the beneficial owner of the interest.

25. Where interest is deductible in computing the profits attributable to a non-resident's permanent establishment or fixed base in a country, the interest is deemed to arise in that country and the country is entitled to impose withholding tax on the payment; however, unless such a withholding tax is imposed under the country's domestic law, the treaty provision is irrelevant since the treaty itself does not impose tax. The imposition of withholding tax on the interest in this situation is important because it offsets the effect of the deduction of interest by the non-resident in computing the profits attributable to the permanent establishment or fixed base. For this purpose, it is important for the tax authorities of the developing country in which the permanent establishment or fixed base is located to verify that the debt is effectively connected to the permanent establishment or fixed base.

**Deduction of interest under the provisions of tax treaties**

26. In general, the deduction of interest is governed by domestic law rather than the provisions of tax treaties even where the provisions of a tax treaty require the income of a non-resident to be taxed on a net basis. However, tax treaties based on the United Nations Model Convention do impose limits on a country's domestic law with respect to the deduction of interest.

27. First, article 7 (3) of the United Nations Model Convention requires the country in which a permanent establishment is located to allow, when determining the profits attributable to a permanent establishment, deductions for the expenses incurred for the purposes of the business of the permanent establishment. It also provides that such deductions must be allowed irrespective of where the expenses are incurred (that is, in the country where the permanent establishment is located or elsewhere). In addition, the deduction of notional interest expenses for amounts advanced by a permanent establishment to its head office or by the head office to a permanent establishment is explicitly prohibited by article 7 (3) of the United Nations Model Convention, except in the case of financial institutions (in contrast, the commentary on article 7 of the OECD Model Convention indicates that the deduction of such notional interest expenses should be allowed in a wider set of circumstances). Thus, only actual interest expenses incurred by an enterprise for purposes of the business of a permanent establishment are deductible under the United Nations Model Convention.

28. Article 7 (3) deals with the issue of which expenses are attributable to a permanent establishment; it does not deal with the issue of whether those expenses attributable to a permanent establishment are deductible, which is a matter for domestic law (see paragraph 18 of the commentary on article 7 of the United Nations Model Convention, quoting paragraph 30 of the 2008 OECD commentary).

29. Second, although article 14 of the United Nations Model Convention does not contain any provision similar to article 7 (3), the commentary on article 14 provides that the same principles should apply to the computation of the income attributable to a fixed base, including the deduction of expenses.

30. Third, the United Nations Model Convention does not prescribe any particular method for determining the amount of debt and equity of a permanent establishment and the amount of interest to be allowed as a deduction in computing the profits attributable to a permanent establishment. Some guidance on this issue can be found in paragraphs 41 to 44 of the commentary on article 7 of the 2010 OECD Model Convention, as quoted in paragraph 18 of the commentary on the same article of the United Nations Model

Convention, as well as in the OECD *2010 Report on the Attribution of Profits to Permanent Establishments* (available from http://www.oecd.org/ctp/transfer-pricing/45689524.pdf).

31. Fourth, under article 24 (3) of both the United Nations and OECD Model Conventions, a contracting State is prohibited from taxing a permanent establishment of a resident of the other contracting State less favourably than it taxes its own enterprises carrying on similar activities. Thus, where a tax treaty containing article 24 (3) applies, a country must allow non-residents to deduct interest expenses attributable to a permanent establishment on the same terms and conditions that apply to the deduction of interest by residents. However, where a country levies a branch-level interest tax (that is, a tax on the amount of any interest deducted in computing the profits attributable to a permanent establishment), article 24 (3) does not apply because the tax is not levied on the permanent establishment, but on the enterprise to which the interest is considered to be paid. Article 24 (3) applies only to the tax imposed on a permanent establishment, and not to any connected requirements, such as information reporting and penalties. Finally, article 24 (3) does not apply to the taxation of income attributable to a fixed base under article 14 of the United Nations Model Convention.

**Restrictions on the taxation of residents under tax treaties**

32. Although tax treaties do not generally limit the power of a country to tax its own residents (a principle which is now expressly stated in article 1 (3) of the United Nations and OECD Model Conventions), there are a few exceptions to this general principle that are relevant with respect to interest.

33. First, under article 23 of both the United Nations and OECD Model Conventions, the residence country is under an obligation to provide relief from double taxation with respect to an item of income that is taxable by the source country in accordance with the provisions of the treaty. This obligation must be met by exempting that income from residence country tax or by granting a credit against the residence country's tax for the foreign tax paid on that income. As explained above, in principle, any interest expense incurred by a resident of a country to earn foreign-source income that is exempt from residence country tax would not be deductible; also, where foreign-source income is taxable by the residence country, any interest expense incurred to earn that income would be deductible but would be allocated to that income for purposes of computing the limitation on the foreign tax credit.

34. Second, article 24 (4) of both the United Nations and OECD Model Conventions requires a contracting State to allow the deduction of interest (and other payments) by an enterprise of that State to a resident of the other contracting State under the same conditions as if the amounts had been paid to a resident of the first State. This provision does not apply to excessive payments of interest under article 9 or article 11 (6). For example, article 24 (4) would prevent a country from denying the deduction of interest paid by a resident to a non-resident where a deduction would be allowed for a similar payment of interest to another resident. Article 24 (4) would also prevent a country from applying thin capitalization rules or earnings-stripping rules to prevent the deduction of excessive interest paid to non-residents unless those rules are compatible with the arm's length standard under article 9 or are also equally applicable to interest paid to residents.

35. Third, under article 24 (5) of both the United Nations and OECD Model Conventions, resident enterprises of one State owned or controlled by residents of the other State must not be subjected to taxation or any connected requirement that is different from or more burdensome than the treatment of similar resident enterprises. For example, article 24 (5) would prohibit the application of rules for the deduction of interest paid by a resident company owned or controlled by non-residents that are

less favourable than the rules for the deduction of similar interest paid by resident companies owned by residents.

# III. Countermeasures to prevent base erosion with respect to interest expenses

### Introduction

36. Each developing country must decide for itself whether and to what extent it is concerned about the risks of base erosion identified above with respect to interest, and if so, how best to deal with those risks. This part of the summary identifies possible countermeasures that developing countries might adopt to deal with the major risks of base erosion arising from the provisions of a developing country's domestic law or from its tax treaties with respect to interest. The following material is intended as guidance, not as recommendations, for developing countries to consider in deciding whether to adopt countermeasures to prevent base erosion and in deciding on the application of those measures.

37. Base erosion through interest payments occurs because the payments are deductible by the payer, and is exacerbated where the payments are not taxable to the recipient and/or the related income is exempt from tax or taxed at a preferential rate. The risks of base erosion with respect to payments of interest are clearly greatest where the payments are deductible against a country's tax base and are made to non-residents. Such interest payments ordinarily reduce the payer's income subject to tax and are not subject to tax or are subject to a reduced rate of tax to the non-resident recipient.

### Countermeasures under domestic law

*Restrictions on the deduction of excessive interest*

38. As discussed above, interest may be considered excessive where the interest rate is higher than the interest rate on arm's length debt with similar terms, where the amount of debt is excessive, or where the amount of deductible interest is excessive based on some debt-equity ratio or interest-earnings ratio. A wide range of countermeasures is available to developing countries for dealing with the problem of excessive interest, although the effectiveness of these measures varies considerably. For example:

(a) Transfer pricing rules may be used to attack the deduction of excessively high interest rates and interest on excessive amounts of debt (see the *United Nations Practical Manual on Transfer Pricing for Developing Countries*); however, transfer pricing rules are difficult to apply effectively, especially for developing countries that may lack adequate administrative resources and expertise and they usually apply only to interest payments to related or associated enterprises;

(b) A general limitation restricting the deduction of expenses, including interest, to a reasonable amount; however, such a limitation is vague, general and uncertain and may be ineffective;

(c) A general anti-avoidance rule; however, a general anti-avoidance rule is usually targeted at sophisticated tax avoidance arrangements rather than excessive deductions.

As a result of these concerns, some countries have decided that specific restrictions on the deduction of excessive interest — thin capitalization rules or earnings-stripping rules — are more likely to be effective.

39. Thin capitalization rules are typically applied to deny the deduction of interest paid by a resident company to either:

(a) A substantial (defined as a shareholder that owns 5, 10 or 25 per cent or more of the shares of the resident company) or controlling non-resident shareholder that holds a disproportionate amount of debt of the resident company relative to its equity shares in the company. Under thin capitalization rules that apply in this manner, the excessive portion of the non-resident shareholder's debt in the resident company is considered to be disguised equity;

(b) Any non-resident if the resident company has excessive debt relative to its equity. Under thin capitalization rules that apply in this manner, any interest paid to non-residents is not deductible to the extent that the resident company's debt-equity ratio exceeds a specified ratio.

Earnings-stripping rules are similar in principle to the second type of thin capitalization rules, except that excessive interest is measured by reference to an entity's interest expenses relative to its earnings.

40. Developing countries may want to consider applying thin capitalization or earnings-stripping rules to interest deductions claimed by non-residents in computing income that is taxable on a net basis. In addition, the tax authorities of developing countries may want to ensure that non-residents do not deduct excessive interest expenses in computing net income earned in a country by allocating excessive debt to the business carried on in that country.

41. Developing countries that decide to adopt thin capitalization or earnings-stripping rules need to carefully consider many difficult tax policy issues in designing the rules. These legislative design issues and sample legislation with explanatory notes can be found in the Practical Portfolio on Interest.

**Deductible interest payments to non-residents: withholding tax on interest**

42. Since interest payments to non-residents that are deductible against a country's tax base reduce its tax base, in principle, the country should impose withholding tax on such payments at a rate that offsets the tax saving from the deduction. However, withholding tax on interest is often borne by resident borrowers and as a result, withholding tax levied on interest at a high rate may limit access of resident businesses to foreign capital markets. As a result, some countries may wish to impose withholding taxes on interest under domestic law or their tax treaties at a lower rate or even exempt certain payments of interest from withholding tax.

43. Developing countries should consider ensuring that any deductible interest payments made by non-residents to other non-residents are subject to withholding tax. Sample legislation with explanatory notes with respect to withholding tax on interest is included in the Practical Portfolio on Interest.

**Restrictions on the deduction of interest by non-residents**

44. Developing countries might consider the following countermeasures to deal with base erosion through deductible interest expenses incurred by non-residents:

(a) Deny the deduction of all interest expenses incurred by non-residents or all interest expenses paid by non-residents to non-resident lenders. Such a measure is generally viewed as arbitrary and inappropriate because interest expenses are legitimate income earning expenses that should be deductible. In addition, as discussed below, to the extent that a developing country has entered into tax treaties with a non-discrimination provision similar to article 24 (3) of both the United Nations and OECD Model Conventions, that provision will prevent the developing

country from limiting or denying the deduction of interest by non-residents carrying on business through a permanent establishment unless similar restrictions are applied to residents of the developing country;

(b) Deny the deduction of interest paid by non-residents to non-resident lenders unless the non-resident payers withhold tax from such payments. As discussed below, to the extent that a developing country has treaties containing provisions similar to article 24 (3) of the United Nations and OECD Model Conventions, those provisions will prevent this type of condition on the deduction of interest unless it applies equally to resident payers;

(c) Apply robust audit and verification administrative measures to ensure that any interest deductions claimed by non-residents are appropriate.

**Deductible interest expenses to earn exempt or preferentially taxed income**

45. As mentioned above, base erosion from interest deductions claimed by residents is a serious problem for a country whenever the associated income is exempt from tax, is taxed at a preferential rate or can be deferred for a substantial period. For developing countries that are primarily capital-importing countries, this aspect of base erosion through interest payments is much less important than the other aspects of base erosion; therefore, the possible responses to this type of base erosion are discussed only briefly in the present summary.

46. Where a developing country exempts foreign-source income, it should not, in principle, allow the deduction of any expenses, including interest, incurred to earn such income.

47. Where a developing country imposes tax on foreign-source income earned by residents, it will usually allow a deduction for interest expenses incurred to earn the income and grant a credit for foreign tax on the income. The foreign tax credit should be limited to the developing country's domestic tax on the foreign-source income. Whether foreign-source income is exempt or taxable with a foreign tax credit, the developing country should consider having clear rules — tracing, ordering rules, or apportionment — to allocate interest expenses to foreign-source income and should consider vigorously enforcing these rules.

48. Similar responses should be used to deal with the risks of base erosion where residents of a developing country incur interest expenses to acquire shares of a foreign company. Where dividends received by a resident from the foreign company are exempt, any interest expenses incurred by the resident to acquire the shares should, in principle, not be deductible. Also, where dividends from foreign companies are taxable, the deduction of interest should in principle be deferred until dividends are received; if the country provides an indirect foreign tax credit for the underlying foreign corporate tax on the income out of which the dividends are paid, any interest expenses should in principle be allocated to that income for purposes of the limitation on the foreign tax credit. In both cases, developing countries require clear rules — tracing, ordering, or apportionment rules — for allocating interest expenses to the shares of non-resident companies, and the tax authorities should be vigilant in applying those rules to ensure that any interest expenses are properly allocated for this purpose.

**Special risks and countermeasures**

49. Taxpayers have opportunities to use back-to-back arrangements to avoid withholding taxes on interest and restrictions on the deduction of interest. For example, withholding taxes may be imposed only on payments of interest to non-residents with whom the payer does not deal at arm's length; as a result, a

non-resident may place funds on deposit with an arm's length financial institution on condition that the financial institution loan the funds to a resident company that does not deal at arm's length with the non-resident. The payments of interest to the financial institution would not be subject to withholding tax, but withholding tax would have applied if the non-resident had loaned the funds directly to the resident company. Developing countries might adopt specific anti-avoidance rules or apply a general anti-avoidance rule to deal with abusive back-to-back arrangements.

50. Where a foreign company acquires the shares of a company resident in a developing country, a common tax avoidance strategy is to use a "debt push-down arrangement" to shift the debt (and the related interest expense) used to finance the acquisition to the acquired company in the developing country. The result of such an arrangement is that the interest expense on the acquisition debt will be deducted against the tax base of the developing country rather than against the tax base of the country in which the foreign company is resident. Designing an appropriate response for debt push-down arrangements is very difficult because they can take different forms and because not all such arrangements are abusive. If a developing country has thin capitalization or earnings-stripping rules, those rules may limit, but not completely deny, the interest deductions from debt push-down arrangements. Developing countries might consider enacting specific anti-avoidance rules to deal with abusive debt push-down arrangements or applying a general anti-avoidance rule if it has such a rule.

**Countermeasures under tax treaties**

51. Tax treaties entered into by a country that contain provisions similar to articles 24 (4) and 24 (5) of the United Nations and OECD Model Conventions may prevent that country from applying thin capitalization or earnings-stripping rules that apply only to interest paid to non-residents. To avoid this result, a country might:

(a) Decline to enter into tax treaties;

(b) Refuse to agree to the inclusion of articles 24 (4) and 24 (5) in its tax treaties;

(c) Enact thin capitalization or earnings-stripping rules that apply to interest paid to both residents and non-residents;

(d) Provide an exemption from the thin capitalization or earnings-stripping rules where interest paid to non-residents complies with the arm's length standard in article 9;

(e) Insist on expressly excluding its thin capitalization or earnings-stripping rules from articles 24 (4) and 24 (5);

(f) Insist on limiting articles 24 (4) and 24 (5) to most-favoured-nation treatment rather than national treatment.

52. Article 24 (3) of the United Nations Model Convention may prevent a developing country from applying its thin capitalization or earnings-stripping rules to interest paid by non-resident enterprises resident in the other contracting State carrying on business in the developing country through a permanent establishment. To avoid this result, a developing country might:

(a) Decline to enter into tax treaties;

(b) Refuse to include article 24 (3) in its tax treaties, although other countries are likely to insist on its inclusion;

(c) Enact thin capitalization or earnings-stripping rules that apply equally to interest borne by permanent establishments and interest paid by resident companies;

(d) Insist on limiting article 24 (3) to most-favoured-nation treatment rather than national treatment.

53. A country's tax treaties may prevent the country from imposing its withholding tax on certain payments of interest to residents of its treaty partners or may require it to reduce its rate of withholding tax on interest payments to residents of its treaty partners. Developing countries could insist on maintaining reasonable rates of withholding tax on interest, such as 10 or 15 per cent, in their treaties, which would reduce the extent of any base erosion through deductible interest payments. However, non-resident lenders may require resident borrowers to bear the cost of any withholding tax on interest by grossing up the interest payments. Countries should also ensure that any exemptions from withholding tax on interest are clearly justified.

54. In certain circumstances, article 7 (3) of the United Nations Model Convention could prevent a developing country from denying the deduction of interest in determining the profits attributable to a permanent establishment where the interest is incurred for the purposes of the permanent establishment (see para. 26).

55. Developing countries should be especially cautious about entering into tax treaties that provide for different rates of withholding on certain types of interest, since tax treaties with low rates or exemptions from withholding tax may encourage treaty shopping by non-residents.

## IV. Tax administration issues

56. In most situations, non-residents are subject to final withholding taxes on the gross interest payments they receive from residents. The tax withheld is the final tax; the non-resident is not allowed to file a tax return and pay tax on a net basis, except perhaps where the non-resident carries on business in a country. To the extent that non-resident recipients of interest are subject to withholding, the obligations to identify non-residents subject to tax and the amount of the tax are effectively shifted to the withholding agents, although the tax authorities must audit withholding agents to ensure that they meet their obligations. Where non-residents are subject to tax on a net basis, they should be subject to the ordinary audit and verification process, especially with respect to interest paid to non-residents.

57. In order to effectively administer the provisions of domestic law and tax treaties, the tax authorities require the power to gather the necessary information from the taxpayer and other persons, such as financial institutions and withholding agents, and to audit and verify that the provisions of domestic law have been complied with. Therefore, developing countries should consider whether the disclosure and information reporting requirements under its domestic law for any restrictions on the deduction of interest by residents and non-residents, including thin capitalization, earnings-stripping and transfer pricing rules, and for withholding tax on non-residents receiving interest are adequate and whether the resources devoted to audit and verification activities are adequate for this purpose.

58. The tax authorities of developing countries also need to apply the provisions of their tax treaties with respect to the treatment of interest. In this regard, the application of tax treaties involves the determination of:

(a) The residence of a non-resident recipient of interest (often, certificates of residence from the foreign tax authorities are required for this purpose);

(b) Whether article 7 (or article 14 in the case of independent personal services) or article 11 of the treaty applies; in general, article 7 or article 14 will apply to interest received by a non-resident if the non-resident carries on business in the

developing country through a permanent establishment or fixed base, the debt claim is effectively connected to the permanent establishment or fixed base, and the interest income is attributable to the permanent establishment or fixed base;

(c) Whether interest expense incurred by a non-resident is deductible in computing the profits attributable to a permanent establishment or fixed base under article 7 or article 14;

(d) Whether the non-resident qualifies for the benefits of the particular article of the treaty (for example, the non-resident must be the beneficial owner of the interest in order to qualify for the lower rate of withholding in article 11 (2));

(e) Any anti-treaty shopping or limitation-on-benefits provision must not apply.

## Checklist of the major risks of base erosion and possible countermeasures

| *Risk* | *Countermeasure* |
|---|---|
| **Excessive interest deductions** | |
| • Interest payments to related non-residents in excess of arm's length amount | • Apply transfer pricing rules<br>• Enact thin capitalization or earnings-stripping rules |
| • Interest payments to substantial shareholders are in substance payments in respect of their equity investments | • Apply transfer pricing rules (tax treaties will prevent the application of the rules to non-controlling shareholders)<br>• Enact thin capitalization rules or rules to treat some shareholder debt as equity and interest on that debt as not deductible |
| • Interest payments are excessive because the taxpayer has disproportionate debt relative to equity | • Enact effective thin capitalization rules |
| • Interest payments are excessive because they are disproportionate to the taxpayer's earnings (earnings before interest, taxes, depreciation and amortization) | • Enact effective earnings-stripping rules |
| • Provisions of tax treaties (article 24 (4) or article 24 (5)) may prevent the application of restrictions on excessive interest deductions | • Do not enter into tax treaties<br>• Do not agree to include article 24 (4) or 24 (5)<br>• Apply any restrictions on interest deductions to both residents and non-residents<br>• Allow interest deductions if they conform to the arm's length standard in article 9 (1)<br>• Exclude any restrictions on interest deductions from article 24 (4) and article 24 (5) |
| **Withholding taxes on interest** | |
| • No or reduced withholding tax on interest paid to non-residents under domestic law | • Impose high withholding taxes on all interest payments to non-residents<br>(This response could have serious disadvantages) |
| • No or reduced withholding tax on interest paid to non-residents under tax treaties | • Maintain reasonable rates of withholding tax on interest paid to non-residents<br>• Ensure that any exemptions are clearly justified |
| • No withholding tax on payments of deductible interest by non-residents to non-residents | • Ensure that withholding tax on interest applies to payments of interest by non-residents that are deductible in computing their business income earned in the developing country |

| *Risk* | *Countermeasure* |
|---|---|
| **Deductible interest incurred by residents to earn exempt or preferentially taxed income** | |
| •Interest is deductible but foreign-source income is exempt | •Deny deduction of interest<br>•Adopt robust rules for allocating interest expenses to foreign-source income |
| •Foreign-source income is taxable but interest is not allocated to that income for purposes of the limitation on the foreign tax credit | •Limit foreign tax credit to domestic tax on the net foreign-source income<br>•Adopt robust rules for allocating interest expenses to foreign-source income |
| •Interest expenses incurred to acquire shares of foreign companies:<br>(a) where dividends are exempt<br>(b) where dividends are taxable | •Deny deduction of interest<br>•Apply robust rules for allocating interest expenses to exempt dividends<br>•Defer any deduction of interest until dividends are received<br>•Limit foreign tax credit to domestic tax on the dividends<br>•Apply robust rules for allocating interest expenses to taxable dividends |
| **Miscellaneous risks of base erosion through interest deductions** | |
| •Back-to-back arrangements | •Adopt specific anti-avoidance rules to protect restrictions on interest deductions and withholding tax on interest<br>•Apply a general anti-avoidance rule |
| •Debt push-down arrangements | •Adopt restrictions on interest deductions (for example, thin capitalization or earnings-stripping rules)<br>•Adopt specific anti-avoidance rules or apply general anti-avoidance rule |

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**Discussion of substantive issues related to international cooperation in tax matters: other issues: capacity-building**

# Summary of the Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Rent and Royalties

## Note by the Secretariat

1. In its resolution 2017/2, the Economic and Social Council recognized the progress made by the Financing for Sustainable Development Office of the Department of Economic and Social Affairs of the Secretariat in developing, within its mandate, a capacity development programme in international tax cooperation aimed at strengthening the capacity of the ministries of finance and the national tax authorities in developing countries to develop more effective and efficient tax systems, which support the desired levels of public and private investment, and to combat tax evasion, and requested the Office, in partnership with other stakeholders, to continue its work in that area and to further develop its activities, including relevant practical tools.

2. One of the areas of focus of the above-mentioned programme is on strengthening the capacity of developing countries to increase the potential for domestic revenue mobilization by enhancing their ability to effectively protect and broaden the tax base. The main tools developed in this area are: (a) the *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries*; and (b) a series of practical portfolios on protecting the tax base of developing countries.

* E/C.18/2018/8.

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3. The practical portfolios aim to complement and operationalize the guidelines contained in the handbook through more in-depth and hands-on practical guidance tailored to developing countries for dealing with various aspects of tax base erosion. To date, three practical portfolios have been completed and are available in digital format on the website of the Financing for Sustainable Development Office.[1]

4. The paper contained in the annex to the present note is a summary of the Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Rent and Royalties, which focuses on the tax treatment of rent and royalties under the domestic law and tax treaties of developing countries from the perspective of potential tax base erosion and profit shifting.

5. The practical portfolio on rent and royalties is intended to assist tax officials from developing countries in reviewing the provisions of their domestic law and tax treaties dealing with rent and royalties in order to identify the major risks of base erosion and the countermeasures that these countries can take to reduce or eliminate those risks.

6. One of the major risks of base erosion is transfer pricing abuses with respect to cross-border payments of rent and royalties between entities that are part of a multinational group. Transfer pricing is not dealt with extensively in the practical portfolios because the topic is covered in the United Nations Practical Manual on Transfer Pricing for Developing Countries. Instead, the practical portfolio on rent and royalties presents a comprehensive identification of the risks of base erosion with respect to the deduction and taxation of rent and royalty payments and the possible countermeasures to those risks in recognition of the widely varying experiences of developing countries and in order to provide tax officials from developing countries with as much information as possible. In the summary contained in the annex, however, only the most important risks of base erosion with respect to rent and royalties are dealt with.

7. Neither the practical portfolio on rent and royalties nor the summary contained in the annex deals with the domestic laws or tax treaties of particular countries. Instead, they deal with the basic patterns of taxation with respect to rent and royalties that are commonly found in the domestic laws and tax treaties of developing countries. Thus, tax officials from developing countries should adapt the materials to their particular situation.

8. The practical portfolio on rent and royalties contains four parts. Part 1 consists of a general introduction. Part 2 provides an analysis of the provisions of the domestic law and tax treaties of developing countries dealing with the deduction and taxation of rent and royalties, the risks of base erosion with respect to such payments and the possible countermeasures. Part 3 provides guidance for tax officials from developing countries in designing and drafting domestic legislation and in negotiating tax treaties to counter base erosion. Part 4 provides guidance concerning the administrative aspects of the provisions of the domestic laws and tax treaties of developing countries dealing with rent and royalties.

9. The practical portfolio on rent and royalties is available only in English. The summary contained in the annex to this note is intended to provide access to the basic contents of the portfolio in the other five official languages of the United Nations. It is not intended as a substitute for the much more comprehensive analysis of the risks of base erosion and possible countermeasures presented in the portfolio, and readers are encouraged to consult the full portfolio for more detailed information.

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[1] United Nations, Department of Economic and Social Affairs, *Protecting the Tax Base of Developing Countries against Base Erosion: Income from Services* (New York, 2017), *Protecting the Tax Base of Developing Countries against Base-eroding Payments: Interest and Other Financing Expenses* (New York, 2017) and *Protecting the Tax Base of Developing Countries against Base-eroding Payments: Rent and Royalties* (New York, 2017), available from www.un.org/esa/ffd/tax-cooperation/practical-portfolios.html.

# Annex

## Summary of the Practical Portfolio on Protecting the Tax Base of Developing Countries against Base-eroding Payments: Rent and Royalties*

### A. Major risks of base erosion with respect to rent and royalties under domestic law

#### Introduction

1. Although all deductible payments of rent and royalties erode a country's tax base, most payments of rent and royalties for the use of tangible and intangible property are legitimate costs of earning income. However, developing countries may have serious concerns about the inappropriate erosion of their tax base where:

(a) Deductible payments of rent or royalties are made to a related person in excess of the amount that would have been paid if the parties were dealing at arm's length;

(b) Residents of a country, or non-residents who are taxable on a net basis in that country, make deductible payments of rent and royalties to non-residents and those non-residents are not subject to tax by that country on such payments or are subject to tax at a reduced rate;

(c) Residents of a country derive rent and royalties from foreign sources that are not subject to tax by that country or are subject to a preferential rate of tax;

(d) Residents of a country incur deductible rent and royalty expenses to earn foreign-source income that is exempt or subject to a preferential rate of tax by that country;

(e) Residents are allowed to claim generous research and development deductions and then transfer the intellectual property that is created to a related non-resident.

2. The risks of base erosion with respect to rent and royalties are significantly more serious for developing countries where deductible rent or royalties are paid to a non-resident, since developing countries are typically importers of technology and equipment. Accordingly, this summary focuses primarily on rent and royalties paid to non-residents and only briefly discusses the risks of base erosion with respect to residents of a developing country.

#### Basic concepts

3. In this summary, the term "rent" is used to describe payments for the use, including temporary and non-exclusive use, of tangible property under a legal transaction usually referred to as a "lease"; the term "royalties" is used to describe payments for the use of intangible property under a transaction usually referred to as a "licence." However, in the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention), the term "royalties" is used to include both rent for the use of certain equipment and royalties for the use of intangible property.

* The summary has been prepared by Brian J. Arnold, Senior Adviser, Canadian Tax Foundation, Toronto, Canada. The full text of the practical portfolio is available at www.un.org/esa/ffd/wp-content/uploads/2017/05/PP_Rents-Royalties.pdf.

4. Rent and royalties are payments for the use or the right to use property; they are fundamentally different from payments for the transfer of the ownership of property (sales) and payments in consideration for services, although it may be difficult to distinguish between them in some circumstances (for example, in so-called mixed contracts under which one person sells, leases or licenses property to another person and also provides services to that person). For domestic tax purposes, the distinction between the various types of payments is made in accordance with each country's domestic law and these laws may differ significantly. In the context of the United Nations Model Convention and the Organization for Economic Cooperation and Development Model Tax Convention on Income and on Capital (OECD Model Convention), however, the treaty characterization of these payments is made in accordance with the relevant treaty definitions and the substance of these payments regardless of the domestic law. Developing countries can minimize the tax avoidance opportunities arising from the distinction between rent, royalties and fees for services by treating such payments similarly for domestic tax purposes.

5. Depending on the facts, rent and royalties may be characterized as either passive investment income or active business income under a country's domestic law. In contrast, under the United Nations Model Convention, the tax treatment of rent and royalties depends on whether a resident of one contracting state carries on business in the other State through a permanent establishment or fixed base in that State; otherwise, rent and royalties received by a non-resident will usually be subject to a withholding tax.

6. In general, rent and royalties are paid with respect to three basic types of property:

(a) Immovable property, which generally includes land, buildings and other structures affixed to land, and may also include standing timber and other natural resources;

(b) Movable property, which includes machinery and equipment and other tangible property;

(c) Intangible property, which includes patents, trademarks, copyright and know-how, and may even include technical assistance and services in some cases.

7. It is often necessary for taxpayers and developing countries to allocate rent or royalties to income-earning activities, non-income-earning activities and domestic or foreign sources. This allocation can be done on the basis of tracing or apportionment. Tracing involves determining, on the basis of the facts and circumstances, the income or activities to which specific payments of rent or royalties are connected. Apportionment involves allocating rent or royalties expenses to income by reference to the cost or value of assets, gross revenue, turnover or some other factor. Most countries use both tracing and apportionment because, although tracing is easier, it is impossible to apply in certain circumstances.

8. Payments for the use or exploitation of natural resources are often referred to as royalties; however, such payments are similar to user fees and are not usually treated as royalties for tax purposes.

**Taxation of residents**

9. The risks of base erosion from base-eroding payments of rent and royalties are less serious with respect to residents of a developing country than non-residents. The major risks of base erosion with respect to residents are:

(a) The developing country does not tax rent and royalties derived from foreign countries, either because it does not tax foreign-source income generally (so-

called "territorial taxation") or it does not tax certain foreign-source rent or royalties. In this situation, the country's rules for determining the source of rent and royalties (typically the place of use of the property or the residence of the payer) may be manipulated by taxpayers to avoid tax;

(b) Where a developing country does not tax foreign-source income, any deductible rent or royalty expenses incurred by a resident to earn that exempt income will erode the country's tax base;

(c) Where a developing country taxes foreign-source income earned by residents (so-called "worldwide" taxation), it has an obligation to provide relief from double taxation by granting a credit against that country's tax for the foreign tax on the foreign-source income. The foreign tax credit should be limited to the developing country's own tax on the foreign-source income. Any rent and royalties incurred by a resident to earn that income should be allocated to that income for purposes of calculating this limitation on the foreign tax credit; otherwise, the foreign tax credit will be overstated and reduce the developing country's tax on its domestic income;

(d) Where developing countries provide generous tax incentives for research and development or preferential taxation of income derived from certain intellectual property in order to encourage research and development activities in the country (so-called "patent box" regimes), these tax incentives will reduce the country's tax base and may be subject to abuse;

(e) Where a resident of a developing country transfers property that produces rent or royalties to a related non-resident (a controlled foreign corporation, group company or even a permanent establishment — assuming that the country exempts income attributable to a foreign permanent establishment), the country will no longer be able to tax any rent or royalty income generated by that property. Even if the country taxes any gain realized on the transfer of the property, the price for the property may be set at an artificially low amount to reduce the amount of the gain.

**Taxation of non-residents earning income that is taxable on a net basis**

10. Some developing countries impose tax on the net income derived by non-residents from their countries. Typically, such net basis taxation is applicable only where the non-resident's activities in a developing country are substantial — for example, a business is carried on through a permanent establishment or fixed base or the non-resident is present in the developing country for a significant period of time. Some developing countries may also tax non-residents owning immovable property in their countries on a net basis. In these circumstances, non-residents are entitled to deduct expenses, including rent and royalties, incurred to earn the income subject to tax by the developing country.

11. The deduction of rent and royalties by non-residents in these circumstances may result in base erosion where an excessive amount of rent or royalties incurred by a non-resident is allocated to the income earned in the developing country and deducted in computing the non-resident's income subject to tax. For this purpose, the rent and royalties incurred by the non-resident must be allocated between the non-resident's income-earning activities in the source country and its activities outside the source country; however, it is difficult for the tax authorities to determine the proper share of a non-resident's rent or royalties attributable to the income earned in the source country, especially with respect to intangible property. Similar issues arise in connection with the computation of profits attributable to a permanent establishment or fixed base under article 7 of the United Nations Model Convention.

**Taxation of non-residents receiving rent and royalties — withholding tax**

12. Where a resident of a developing country or a non-resident taxable on a net basis in a developing country pays rent or royalties to a non-resident, the payments will usually be deductible against the developing country's tax base. Although all deductions of rent and royalties erode a developing country's tax base, it would be inappropriate for the country to deny those deductions where the rent and royalties are legitimate expenses incurred to earn income. However, if the deductible payments of rent or royalties to non-residents are not subject to tax by the developing country, the risk of base erosion is more serious. Typically, developing countries impose withholding tax on rent and royalties paid to non-residents. Even where withholding tax is imposed on rent and royalties, risks of base erosion occur where:

(a) The tax saving from the deduction of the rent or royalties is greater than the withholding tax. For example, if a developing country has a corporate tax rate of 30 percent but imposes withholding tax on rent and royalties at a rate of only 20 per cent, the country's tax base will be eroded by 10 per cent of the amount of the rent or royalties paid. Establishing the rate of withholding tax on rent and royalties is a difficult balancing act between protecting a developing country's tax base and not discouraging non-residents from leasing and licensing property to residents of the developing country;

(b) Certain rent or royalties are exempt or subject to reduced rates of withholding tax;

(c) Rent or royalties for the use of various types of property are subject to different rates of withholding tax;

(d) The amount of rent or royalties received by a non-resident from a related party is more or less than the amount that would have been paid if they had been dealing at arm's length;

(e) The rent and royalty payments may not be related to the effective use of a right or asset. Where the payments are not incurred for the purpose of earning income or do not produce any benefit for the payer, the deduction of those payments erodes a country's tax base.

13. Where rent is paid to a non-resident for the use of immovable property located in a developing country, it is relatively easy for the country in which the property is located to impose withholding tax on the rent even where the rent is paid by a non-resident (for example, where that non-resident payer carries on business in that immovable property). However, where rent or royalties are paid to a non-resident for the use of movable or intangible property, it may be more difficult for developing countries to determine whether to impose withholding tax on those payments. For example, where a resident of a developing country pays rent or royalties for the use of property outside the developing country, it may be difficult or inappropriate to impose withholding tax on such payments. A rule that combines the place where the property or right is used and the country of residence of the payer may be the most efficient rule.

14. Developing countries could impose withholding tax on all payments of rent or royalties by residents or non-residents with a permanent establishment or fixed base in the country (or non-residents using property within the country if the place of use source rule is used) for the use of movable or intangible property; such a broad tax, however, would be difficult to enforce, especially where payments are made by individuals. Accordingly, an alternative would be to impose withholding tax only if the payments are deductible in computing income subject to tax by the developing

country; under this alternative, non-deductible payments of rent or royalties would not be subject to tax.

## B. Major risks of base erosion with respect to rent and royalties under tax treaties

### Introduction

15. The provisions of tax treaties may sometimes create opportunities for base erosion with respect to rent and royalty expenses because tax treaties limit the taxes imposed by one contracting State on residents of the other contracting State. For any particular developing country, the extent to which its tax treaties allow its domestic tax base to be eroded depends on: (a) how many tax treaties it has concluded; (b) the countries with which it has concluded tax treaties; and (c) the provisions of those tax treaties.

16. In general, tax treaties are based on either the United Nations Model Convention or the OECD Model Convention. Many developing countries negotiate the provisions of their tax treaties on the basis of the United Nations Model Convention because it provides greater taxing rights for source countries.

17. Tax treaties do not generally impose tax; tax is imposed pursuant to a country's domestic law. Therefore, if an amount of income derived by a non-resident from a country is not taxable under that country's domestic law, it is irrelevant whether the country has the right to tax the amount under the provisions of an applicable tax treaty.

### Restrictions on the taxation of residents under tax treaties

18. Although tax treaties do not generally limit the power of a country to tax its own residents, a principle which is now expressly stated in article 1(3) of the United Nations and OECD model conventions, there are a few exceptions to this general principle that are relevant with respect to rent and royalties.

19. First, under article 23 of both model conventions, the residence country is under an obligation to provide relief from double taxation with respect to an item of income that is taxable by the source country in accordance with the provisions of the treaty. This obligation must be met by exempting that income from residence country tax or by granting a credit against the residence country's tax for the foreign tax paid on that income. As explained above, in principle, any rent or royalty expenses incurred by a resident of a country to earn foreign-source income that is exempt from residence country tax would not be deductible; also, where foreign-source income is taxable by the residence country, any such expenses incurred to earn that income would be deductible but would be allocated to that income for purposes of computing the limitation on the foreign tax credit.

20. Second, article 24(4) of both model conventions requires a contracting State to allow the deduction of rent and royalties (and other payments) paid by an enterprise of that State to a resident of the other contracting State under the same conditions as if the amounts had been paid to a resident of the first State. This provision does not apply to excessive payments of royalties under article 9 or article 12(6). For example, article 24(4) would prevent a country from denying the deduction of rent or royalties paid by a resident to a non-resident where a deduction would be allowed for a similar payment made to a resident.

21. Third, under article 24(5) of both model conventions, resident enterprises of one State owned or controlled by residents of the other State must not be subjected to taxation or any connected requirement that is different from or more burdensome than

the treatment of similar resident enterprises. For example, article 24(5) would prohibit the application of rules for the deduction of rent or royalties by a resident company owned or controlled by non-residents that are less favourable than the rules for the deduction of similar payments of rents or royalties made by other resident companies owned by residents.

**Restrictions on the taxation of non-residents under tax treaties**

22. There are two major questions with respect to the treatment of rent and royalties paid or received by non-residents under tax treaties. First, do tax treaties restrict a country's authority to impose withholding tax on rent and royalty payments made to residents of the other contracting State under its domestic law? Second, do tax treaties require a country to allow the deduction of rent and royalties by residents of the other contracting State in circumstances where no deduction would be allowed under domestic law?

23. If non-residents derive rent and royalty payments from a country, the provisions of article 6, 7, 8, 12 or 21 of the model conventions may apply. If a non-resident has a permanent establishment in the country and the underlying property in respect of which the rent or royalties are paid is effectively connected with the activity of that permanent establishment, ordinarily, the non-resident is taxable by the country in which the permanent establishment is located on a net basis under article 7, which contains provisions dealing with the deduction of rent and royalties (and other expenses) incurred in earning income. Otherwise, the gross amount of rent and royalties received by a non-resident is subject to withholding tax (at a rate limited by article 12 in the case of payments taxable under that article).

**Withholding tax on rent and royalties**

24. Article 6 of both model conventions permits developing countries to tax income from a letting (lease) of immovable property located in that country derived by a resident of the other country without any limitations. Thus, developing countries can tax rent for the use of immovable property on a net or gross basis at any rate. Where a developing country allows the deduction of expenses in computing a non-resident's income from immovable property located in the country, it should ensure that the deductions are legitimate and, in the case of non-arm's length payments, are not in excess of the arm's-length amount. If a gross-based withholding tax is imposed on rent for the use of immovable property, the rate could be established so that the tax is a reasonable proxy for a tax on net income.

25. Article 6(2) defines the term "immovable property" by reference to its meaning under the domestic law of the country in which the property is located and also includes livestock, equipment used in agriculture and forestry and licenses for the right to exploit mines and other natural resources.

26. Under article 8 of both model conventions, profits from the operation of ships and aircraft in international traffic are generally taxable exclusively by the country of residence. Thus, rental payments for ships and aircraft leased by a foreign airline or shipping company to a domestic airline or shipping company that are covered by article 8 may result in base erosion where the payments are deductible against the country in which the payer is resident and that country is prevented from imposing withholding tax on the payments.

27. Under article 12 of the United Nations Model Convention, a developing country is entitled to impose withholding tax at a maximum agreed rate on rent for the use of industrial, commercial or scientific equipment arising in the developing country and paid to a resident of the other country. The expression "industrial, commercial or scientific equipment" is not defined in the treaty and, as explained in paragraph 13.2

of the commentary on the United Nations Model Convention, has the meaning that it has under domestic law unless the context requires a different meaning. Rent is deemed to arise in a country where the payer is a resident of that country or where a non-resident has a permanent establishment or fixed base in that country, the obligation to pay rent is connected to the permanent establishment or fixed base and the rent is deductible in computing the profits attributable to the permanent establishment or fixed base. In contrast, article 12 of the OECD Model Convention does not apply to rent for the use of such equipment; instead, such rent is covered by article 7, which means that a developing country in which rent for the use of such equipment arises would be prevented from taxing the rent unless the non-resident has a permanent establishment in the country and that rent is attributable to the permanent establishment.

28. Where a developing country chooses to impose withholding tax on rent for the use of equipment, it should carefully consider that some non-resident lessors may require lessees resident in the developing country to gross up the rent to reflect the withholding tax, with the result that the tax is shifted to the resident lessees and the cost for residents to lease equipment from non-residents will be increased.

29. Article 12 of the United Nations Model Convention also allows the country in which royalties for the use or the right to use intangible property arise to tax those royalties at a rate agreed between the contracting States. Article 12(3) defines such royalties broadly as payments for the use or the right to use copyright of literary, artistic or scientific work, patents, trademarks, plans, designs or models, secret formulas or processes as well as know-how; however, fees for technical services are not royalties and are taxable in accordance with article 12A of the United Nations Model Convention. Royalties are deemed to arise in a country where the payer is a resident of that country or where a non-resident has a permanent establishment or fixed base in that country, the obligation to pay royalties is connected to the permanent establishment or fixed base and the royalties are deductible in computing the profits attributable to the permanent establishment or fixed base. Under the United Nations Model Convention, the place where property is used is irrelevant for purposes of determining where rent or royalties arise. Under article 12 of the OECD Model Convention, royalties are taxable exclusively by the country in which the recipient is resident.

**Deduction of rent and royalty payments by non-residents**

30. In general, the deduction of expenses in computing income is a matter of domestic law, although article 7 of the United Nations Model Convention provides some general rules about deductions for the purposes of determining the profits attributable to a permanent establishment. In addition, article 24(3) precludes a country from discriminating against a resident of the other contracting State carrying on business in the country through a permanent establishment (but not through a fixed base). Article 7(3) provides that expenses incurred for the purposes of the business of the permanent establishment "shall be allowed as deductions" and that those deductions must be allowed irrespective of where the expenses are incurred (that is, in the country where the permanent establishment is located or elsewhere) and irrespective of whether the expenses are incurred wholly or partly for purposes of the permanent establishment. Although article 14 does not contain rules similar to those in article 7(3), paragraph 10 of the commentary on article 14 indicates that the same principles should apply for purposes of computing the income attributable to a fixed base. Thus, any rent or royalty expenses incurred for the purposes of a permanent establishment or fixed base are deductible in computing the profits attributable to the permanent establishment for the purposes of the application of article 7.

31. Movable and intellectual property owned by a non-resident enterprise may be used for the benefit of the entire enterprise rather than solely for the benefit of a permanent establishment or fixed base. For example, the property may be used for purposes of one part of an enterprise for a period of time and then for a different part of the enterprise for the balance of the year; and intellectual property may be used simultaneously for the benefit of different parts of the enterprise. Therefore, it is necessary to allocate the appropriate portion of rent or royalty expenses incurred by a non-resident to a permanent establishment or fixed base. As discussed above, this allocation can be done on the basis of factually tracing the use of property (for example, by reference to the number of hours or days used) or by apportioning the expenses on the basis of factors such as revenue, sales, assets, employees, etc.

32. Only actual rent or royalty expenses incurred by a non-resident enterprise for the purposes of a permanent establishment or fixed base are deductible for purposes of computing profits of the permanent establishment or fixed base. The deduction of notional rent or royalties charged by the head office (or another part of an enterprise) to a permanent establishment in a developing country for the use of industrial, commercial or scientific equipment or intellectual property owned by an enterprise is explicitly prohibited by article 7(3) of the United Nations Model Convention. In contrast, under article 7 of the OECD Model Convention, notional rent and royalties for such property may be deductible. Under the provisions of both model conventions, if a developing country allows the deduction of notional rent or royalties in computing the profits of a permanent establishment or fixed base, its tax base will be eroded and it will be unable to impose any withholding tax on such notional amounts. However, under the provisions of both model conventions, a developing country is entitled to impose withholding tax on actual rent and royalty payments made by a non-resident with a permanent establishment or fixed base in the developing country to another non-resident if the payments are deductible in computing the profits attributable to the permanent establishment or fixed base, since such payments are deemed to arise in the country.

33. Under article 24(3) of both model conventions, a contracting State is prohibited from taxing a permanent establishment of a resident of the other State less favourably than it taxes its own residents carrying on similar activities. Thus, if resident enterprises are taxable on their profits on a net basis, non-residents carrying on business through a permanent establishment must be similarly taxable on a net basis and must be allowed to deduct rent and royalty expenses in the same manner as resident enterprises. For example, article 24(3) would prevent a developing country from imposing a final withholding tax on rent or royalties received by a non-resident with a permanent establishment in the country where the underlying property (immovable property, equipment or intangible property) is effectively connected to the permanent establishment unless rent or royalties paid to residents are also subject to such a final withholding tax. However, article 24(3) would not apply to a branch-level tax on any rent or royalties deductible in computing the profits of a permanent establishment because such a tax is levied on the non-resident recipient of the rent or royalties and not on the permanent establishment.

34. Article 24(3) refers only to the taxation of the profits of a permanent establishment and not to connected requirements. Thus, article 24(3) does not prevent a country from imposing information-reporting requirements, penalties and other administrative rules with respect to the taxation of non-residents carrying on business through a permanent establishment that are different from those imposed on residents carrying on similar activities.

## C. Countermeasures to prevent base erosion with respect to rent and royalties

### Introduction

35. Three basic responses are available for developing countries to deal with cross-border base erosion through payments of rent and royalties: (a) restrictions on the deduction of rent and royalties; (b) the imposition of withholding taxes on payments of rent and royalties to non-residents; and (c) the application of rules, including transfer pricing rules and anti-avoidance rules, to prevent excessive deductible payments of rent and royalties.

### Countermeasures under domestic law

*Restrictions on the deduction of rent and royalties by residents and non-residents*

36. Although all deductions of rent and royalties reduce a developing country's tax base, it would be inappropriate to deny the deduction of rent and royalties where such expenses represent legitimate costs of earning income. The risks of base erosion with respect to deductible payments of rent and royalties are greater where the payments are made to non-residents and are excessive and/or are not subject to tax by the developing country or are subject to a reduced rate of tax. As discussed below, developing countries may wish to ensure that rent and royalties paid to non-residents are subject to withholding tax.

37. Payments of rent or royalties to non-residents may be excessive where the payer and the recipient of the payments are related or do not deal at arm's length. Developing countries may want to consider the adoption of robust transfer pricing rules to prevent base erosion through excessive rent and royalties paid to related non-residents; they may also want to consider enacting similar anti-avoidance rules to prevent the deduction of excessive payments of rent and royalties between related individuals.

38. Non-residents who are taxable by developing countries on a net basis (for example, where they have a permanent establishment in that country) may allocate disproportionate amounts of rent or royalties to their income-earning activities in such developing countries and deduct those amounts in computing their income. To prevent this result, developing countries may want to enact clear rules for allocating rent and royalties incurred by a non-resident to the income from the business carried on by the non-resident in their countries, and the tax authorities should be vigilant in applying those rules.

*Withholding tax on rent and royalties*

39. Although payments of rent and royalties to non-residents erode a developing country's tax base, that base erosion can be offset if the country imposes tax on the payments. Usually, such a tax is imposed as a flat-rate withholding tax on the gross amount of the payments and the rate is established as a proxy for a tax on the non-resident's net income. A developing country's tax base will still be eroded to the extent that any rent or royalties paid to non-residents are exempt from tax or the rate of withholding tax is less than the tax saving from the deduction of the rent and royalties by the payer. Because high rates of withholding tax on rent or royalties may have the effect of limiting access by residents of a developing country to equipment and technology, developing countries often agree to exemptions or reduced rates of withholding tax on royalties in their tax treaties. However, it is important that any such exemptions or reduced rates be carefully reviewed to ensure that they are

justified. Sample legislation imposing withholding tax on rent and royalties with explanatory notes is provided in the practical portfolio on rent and royalties.

40. If a developing country has different rates of withholding tax on payments of rent and royalties and other payments to non-residents, such as interest and fees for services, taxpayers may manipulate transactions in order to avoid or minimize withholding taxes by altering the character of payments. Developing countries can minimize this risk of base erosion by maintaining consistent rates of withholding under their domestic law and their tax treaties on all payments to non-residents.

41. Where non-residents are taxable on a net basis and deduct payments of rent and royalties against a country's tax base, that country's tax base will be eroded by the deductions except to the extent that such payments are subject to withholding tax.

42. Non-residents may enter into back-to-back arrangements to avoid withholding tax on rent or royalties. To prevent this type of tax avoidance, developing countries can either adopt specific anti-avoidance rules to deal with abusive back-to-back arrangements or, if they have a general anti-avoidance rule, apply that rule to such arrangements.

43. If a developing country imposes withholding tax on rent paid to non-residents for the use of immovable property located in the country, it could consider ensuring that its domestic-law meanings of "immovable property" and "income from" such property are sufficiently broad for this purpose. For example, those meanings might include payments for the use of natural resources — mines, agricultural property, timber – and for the use of property affixed to immovable property, such as pipelines.

44. Similarly, a developing country may find it helpful to review the meanings of "rent" and "royalties" under its domestic law to ensure that they are sufficiently broad to cover all payments for the use of property, that any exemptions are justified and that the meanings are consistent with the meaning of royalties in its tax treaties.

45. Non-resident enterprises may be able to earn substantial amounts in the form of rent or royalties from resident consumers without the need to establish a permanent establishment or fixed base in the country. This type of tax avoidance is not limited to rent and royalties, but may occur with respect to a variety of businesses, including the provision of digital goods and services. The imposition of a withholding tax on all rent and royalties paid to non-residents is unlikely to be an effective response to this type of base erosion since such a tax is difficult to collect from individual consumers. Some countries have enacted special anti-avoidance rules or adopted rules to tax non-residents if they have substantial supplies of digital goods and services in a country.

*Taxation of residents*

46. Where residents of a developing country incur rent or royalties to earn exempt income from foreign sources, in principle, those expenses should not be deductible. Where such expenses are incurred to earn taxable foreign-source income, they are generally deductible, but should in principle be allocated to, and reduce, the foreign income for purposes of the limitation on any foreign tax credit allowed by the developing country. http://www.un.org/esa/ffd/wp-content/uploads/2017/05/PP_Rents-Royalties.pdf.

47. To counter the risks of base erosion where a resident of a developing country transfers intangible property to a non-resident, the developing country might consider taxing any gain realized on the transfer. Where the property is transferred to a related non-resident, there is a risk that the sale price of the property may be less than its fair market value in order to minimize the amount of the gain subject to tax. Developing countries may want to consider including provisions in their domestic law to deem

the proceeds of sale to be equal to the fair market value of the property with respect to such related party sales and may even consider using hindsight for the purpose of determining the value of such property. They should also ensure that they allocate sufficient resources to enforce such provisions effectively.

**Countermeasures under tax treaties**

48. A developing country's tax treaties may prevent it from imposing withholding tax on certain payments of rent or royalties to residents of its treaty partners, or may require it to reduce its rate of withholding tax on such payments. Developing countries could insist on maintaining reasonable rates of withholding tax on rent and royalties — such as 10 or 15 per cent — in their treaties, which would reduce the extent of any base erosion through deductible payments of rent and royalties. However, as noted above, non-resident owners of intellectual property may require resident licensees to bear the cost of any withholding tax by grossing up the royalty payments. Developing countries may also want to ensure that any exemptions from withholding tax on rent and royalties are clearly justified and, to the extent possible, should consider ensuring that the rates of withholding tax on various types of royalties and other payments, such as interest and fees for services, are consistent.

49. Developing countries should ensure that their tax treaties include provisions similar to article 6 of the United Nations Model Convention and, as noted above, they should consider imposing tax under domestic law on all income from immovable property that it is entitled to tax under article 6.

50. Where developing countries agree to include article 12(3) of the OECD Model Convention in their tax treaties, they will be unable to tax rent for the use of industrial, commercial and scientific equipment unless the non-resident lessor has a permanent establishment in their country and the equipment is effectively connected to the permanent establishment. In contrast, if developing countries include article 12(3) of the United Nations Model Convention in their tax treaties, they will be able to impose withholding tax at an agreed rate on rent for the use of such equipment.

51. With respect to royalties for the use of intangible property, developing countries may want to ensure that any payments that are subject to withholding tax under domestic law are also taxable under article 12(3) and that any exemptions from withholding tax under article 12 are clearly justified.

52. To the extent that a country has entered into tax treaties that contain a non-discrimination provision similar to article 24(3) of the United Nations Model Convention, those treaties will prevent the country from denying the deduction of rent and royalties by non-residents carrying on business in the country through a permanent establishment (although not through a fixed base) unless residents of the country are not allowed to deduct similar payments. Although tax treaties generally require countries in which a permanent establishment is located to allow the deduction of rent and royalties that are properly attributable to the permanent establishment, the tax authorities of developing countries should be careful not to allow non-residents to deduct disproportionate amounts. Developing countries should consider not adopting article 7 of the current OECD Model Convention in their treaties because that article may require them to allow deductions for notional rent and royalties in computing the profits attributable to a permanent establishment without being able to collect a withholding tax on such notional payments.

53. Tax treaties entered into by a country that contain provisions similar to articles 24(4) and (5) of both model conventions may prevent that country from restricting the deduction of rent or royalties in certain cases. To avoid this result in cases where a country considers that such restrictions are justified and essential, a country might:

(a) Decline to enter into tax treaties;

(b) Refuse to agree to the inclusion of articles 24(4) and (5) in its tax treaties;

(c) Apply any restrictions on the deduction of rent and royalties by non-residents also to payments of rent and royalties by residents;

(d) Insist on expressly excluding any restrictions on the deduction of rent and royalties to non-residents from articles 24(4) and (5); or

(e) Insist on limiting articles 24(4) and (5) to most-favoured-nation treatment rather than national treatment.

## D. Tax administration issues

63. In general, non-residents may be taxable on rent or royalties as part of their net income in the same manner as residents or on the gross rent and royalties they receive without any deductions. Where non-residents are subject to tax on their net income, they are usually required to file tax returns showing their income subject to tax and the tax payable. Although the payments of domestic-source rent and royalties that such non-residents receive in these circumstances may be subject to withholding, such withholding is provisional; it represents payments on account of the non-resident's tax payable as finally established by the assessment of the non-resident's tax return. Where non-residents are subject to withholding taxes on the gross payments they receive, the tax withheld is usually the final tax. The non-resident is not allowed to pay tax on a net basis, although in some circumstances a non-resident may be allowed to file a tax return and claim a refund for excessive tax withheld.

64. Where non-residents are taxable by assessment, the tax authorities face the difficult task of identifying non-residents who are required to file tax returns, verifying that their income has been computed accurately and collecting tax payable. These difficulties can be minimized if non-residents are subject to interim or final withholding. To the extent that non-residents are subject to withholding, the obligations to identify non-residents subject to tax and to determine the amount of the tax are effectively shifted to withholding agents.

65. In order to effectively administer the provisions of domestic law and tax treaties, the tax authorities require the power to gather the necessary information from the taxpayer and other persons, such as financial institutions and withholding agents, and to audit and verify that the provisions of domestic law have been complied with. Therefore, developing countries may want to consider whether the disclosure and information-reporting requirements under their domestic law and the resources devoted to audit and verification activities are adequate for this purpose.

66. The tax authorities of a developing country also need to apply the provisions of its tax treaties with respect to rent and royalties. The application of the provisions of tax treaties with respect to rent and royalties involves the determination of:

(a) The residence of a non-resident recipient of rent or royalties (often, certificates of residence from the foreign tax authorities are required for this purpose);

(b) The applicable article of the treaty (for example, article 6, 7, 8, 12 or 21);

(c) Whether the non-resident qualifies for the benefits of the particular article of the treaty;

(d) Where a non-resident is taxable in accordance with the provisions of article 7 or article 14, whether rent or royalty expenses are deductible in computing the profits attributable to the permanent establishment or fixed base;

(e) Whether the rent or royalty payments to associated non-residents conform to arm's-length amounts for purposes of articles 9 and 12(6) of the United Nations Model Convention;

(f) Whether the proper amount of withholding tax has been withheld in accordance with the relevant article of the treaty and whether any excess must be refunded.

## Appendix

### Checklist of the major risks of base erosion and possible countermeasures

| Risk | Countermeasures |
|---|---|
| **Deductions of rent and royalties** | |
| • Payments of rent or royalties to related non-residents in excess of arm's-length amounts | • Apply transfer pricing rules |
| • Provisions of tax treaties (article 24(4) or (5)) may prevent application of legitimate and essential restrictions on deductions of rent or royalties | • Don't enter into tax treaties<br>• Don't agree to include article 24(4) or (5)<br>• Apply restrictions on deductions of rent or royalties to both residents and non-residents<br>• Exclude any restrictions on deductions of rent or royalties from article 24(4) and (5)<br>• Limit article 24(4) and (5) to most-favoured-nation treatment |
| • Non-residents subject to net-basis tax may claim excessive deductions of rent or royalties | • Apply restrictions on deductions of rent or royalties to non-residents<br>• Apply robust rules for allocating rent or royalty expenses to income earned by non-residents<br>• Ensure that notional rent and royalties are not deductible and no mark-up on rent or royalty expenses is allowed |
| • Provisions of tax treaties (article 24(3)) may prevent application of rules to disallow excessive deductions of rent or royalties for permanent establishment | • Don't enter into treaties<br>• Don't agree to include article 24(3)<br>• Apply any restrictions on deductions of rent or royalties to both permanent establishment and resident enterprises<br>• Exclude any restrictions on deductions of rent or royalties from article 24(3)<br>• Limit article 24(3) to most-favoured-nation treatment |
| **Withholding taxes** | |
| • No or reduced withholding tax on rent or royalties paid to non-residents under tax treaties | • Maintain reasonable rates of withholding tax on rent and royalties paid to non-residents<br>• Ensure that any exemptions are clearly justified |
| • Withholding tax imposed at different rates on royalties and other amounts, such as interest and services | • Ensure that consistent rates of withholding tax are imposed under domestic law and tax treaties |
| • No withholding tax on payments of deductible rent | • Ensure that withholding tax on rent and royalties applies to payments of rent or royalties by non-residents that are |

| | |
|---|---|
| or royalties by non-residents | deductible in computing their income earned in the source country |
| • Non-residents claim benefit of reduced rate of withholding under tax treaties | • Ensure that non-residents are entitled to treaty benefits under article 12 |
| • Taxpayers may enter into back-to-back arrangements to avoid or reduce withholding tax | • Adopt specific anti-avoidance rules to prevent abusive back-to-back arrangements<br>• Apply general anti-avoidance rule to abusive back-to-back arrangements |
| • No withholding tax on rent for the use of equipment under article 12 of tax treaties | • Ensure that tax treaties contain a provision similar to article 12 of the United Nations Model Convention, which allows withholding tax on rent for the use of equipment |
| • Meaning of immovable property and income from immovable property under domestic law may be too narrow | • Ensure that the meaning of immovable property is at least as broad as the definition in article 6 of the United Nations Model Convention and that the meaning of income from immovable property covers all types of income |
| • The definition of royalties under domestic law may be too narrow or inconsistent with the definition under tax treaties | • Review royalty payments subject to withholding tax under domestic law<br>• Ensure that any exemptions from withholding tax are justified<br>• Compare withholding tax under domestic law and tax treaties and ensure that tax treaties do not limit domestic withholding tax inappropriately<br>• Apply anti-abuse rules to prevent arrangements from avoiding withholding tax on royalties |
| **Special risks of base erosion** | |
| • Intangible property is transferred by a resident to a related non-resident and perhaps leased back to the resident | • Impose tax on gain; ensure that property is deemed to be transferred for its fair market value (perhaps use hindsight to determine fair market value)<br>• If residence country allowed special deductions for research and development expenses, recapture deductions when the property is transferred to a non-resident<br>• Apply a general anti-avoidance rule, if available, in abusive cases |